STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

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TO: PARTIES OF RECORD IN R.05-04-005

This is the proposed decision of Commissioner Rachelle Chong. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure," accessible on the Commission's website at http://www.cpuc.ca.gov. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages.

Comments must be filed with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 2.3 and 2.3.1. Electronic copies of comments should be sent to ALJ Reed at jar@cpuc.ca.gov and Tim Sullivan, Advisor to Commissioner Chong at tjs@cpuc.ca.gov. All parties must serve hard copies on the ALJ and the assigned

Commissioner, and for that purpose I suggest hand delivery, overnight mail or other expeditious methods of service. The current service list for this proceeding is available on the Commission's web site, www.cpuc.ca.gov.

/s/ ANGELA K. MINKIN by J.A. ECONOME
Angela K. Minkin, Chief
Administrative Law Judge

ANG:vfw

Attachment

Decision **PROPOSED DECISION OF COMMISSIONER CHONG**
Mailed 7/25/2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the Regulation of Telecommunications Utilities.	Rulemaking 05-04-005 (Filed April 7, 2005)

O P I N I O N

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I. Summary

In this proceeding, we evaluate both statutory guidance and market conditions in determining whether we may rely more heavily on competitive forces to produce "just and reasonable" rates for California's telephone consumers.

As a result of our statutory and market analysis, we grant carriers broad pricing freedoms concerning almost all telecommunications services, new telecommunications products, bundles of services, promotion, and contracts. We simplify all tariff procedures, making tariffs effective after one day, although we require all carriers to provide a twenty-five-day notice to customers of any proposed price increase. We make contracts effective when executed, ending the necessity of post-signing reviews by this Commission. With few exceptions, we permit carriers to add all services to "bundles" and to target services to specific geographic markets.

We find, however, that continued pricing regulation is warranted in a few specific circumstances relating to public policy programs. In particular, when a particular service receives a social program subsidy, such as LifeLine residential service and basic residential service in areas receiving the California High Cost Fund-B (CHCF-B) subsidies, we adopt certain restrictions. In particular, we adopt a two-year price freeze on the price of basic residential service in order to address the statutorily-mandated link between the LifeLine rate and the basic residential service rates in our pending Universal Service Public Policy Program OIR. In addition, we prohibit the inclusion of basic residential service in "bundles" or "promotions" in those areas receiving a CHCF-B subsidy. Similarly, we prohibit the inclusion of LifeLine services in "bundles" or "promotions."

We also reduce and eliminate many of the vestiges of rate of return regulation, such as "accounting adjustments" and other rules that cause regulatory accounts to diverge from financial accounts. We believe that these regulatory adjustments, which no longer serve a ratemaking purpose, simply make a utility's accounts less understandable. We instead standardize on Generally Accepted Accounting Principles (GAAP) accounting standards and streamline our audit practices. We eliminate the price cap index, price cap filings, earnings "sharing," and gain-on-distributions no longer appropriate in open and competitive telecommunications markets.

We eliminate all monitoring reports tied to the now outdated New Regulatory Framework (NRF) governing the incumbent local exchange carriers affected herein, and instead standardize our reporting requirements to the comprehensive reports provided by all carriers for the Federal Communications Commission (FCC). We set Phase 2 as the proceeding for determining what reports are needed and permit parties to recommend reporting requirements consistent with the new rules that we adopt today.

With our last major review of the telecommunications regulatory framework establishing NRF being eighteen years ago, we acknowledge that this review is overdue. Our review of current market structuring regulations adopted by the FCC as a result of the Telecommunications Act of 1996 and subsequent actions by this Commission, as well as the observed rapid pace of technological developments in telecommunications, convinces us that competitive pressures now are sufficient to check incumbent local exchange carriers' (ILECs') exercise of market power in all but a few instances.

In particular, we find that the market for voice communications services has dramatically changed in the eighteen years since our last review in NRF.

This market now includes multiple wireless carriers, competitive local exchange carriers (CLECs),[1] cable television companies who have added Voice over Internet Protocol (VoIP) telecommunications products to their "triple play" voice, video and data offerings, and pure-play VoIP providers such as Vonage or Packet8, who will add a voice communications service to any broadband connection.

With these market changes, the mid-size and large ILECs[2] have urged the Commission in this proceeding to give them greater pricing flexibility to meet the new competition. Currently, ILECs are subject to complex regulations that were first enacted eighteen years ago under the NRF regime which had strong roots in cost-of-service regulation. There, the Commission's control of prices was viewed as critical to ensuring that rates were just and reasonable. Moreover, since only one incumbent local telephone carrier provided the telecommunications services, delays in the change of a price or the introduction of a service had few market consequences, because customers could not take their business elsewhere. The NRF framework is no longer relevant to today's competitive communications marketplace, because it predates the Telecommunications Act of 1996, the addition of multiple wireless industry players,[3] the rise of the Internet and its revolutionary VoIP technologies, and

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[1] The CLECs often provide service on Unbundled Network Element-Loops (UNE-L) leased from the ILEC and their own telecommunications switching infrastructure.

[2] For the purposes of this decision, general discussion of "ILECs" only applies to mid-size and large California ILECs, which include AT&T, Frontier, SureWest, and Verizon.

[3] These new wireless competitors include Personal Communications Services, Specialized Mobile Radio, and other FCC-licensed wireless technologies,

broadband technologies delivered through ILEC Digital Subscriber Lines (DSL) or cable modem technology.

NRF mapped all ILEC services into categories, and established different pricing rules for each service. As a result, ILECs who now attempt to serve the needs of consumers by offering a bundle of telecommunications services face a patchwork quilt of different regulations that apply to different parts of the bundle. Moreover, it can take months to work through the complex NRF-related regulatory issue.[4]

ILECs face pricing difficulties not only in bundling their legacy services, but in their new service offerings as well. Under current regulations, a NRF utility must file an advice letter 30 days in advance of the introduction of a new product service, or technology.[5] Along with the advice letter filing, the ILEC is required to justify its pricing with cost data and provide other data depending on the category of the service.[6] If no protest is received and the Commission does not initiate a suspension, the new tariff is approved and the service, technology,

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[4] See, e.g., Ex. 33, Opening Declaration of Timothy McCallion at 8 (McCallion testifying that when Verizon attempted to offer a bundle of services called "Local Packages" it took close to a year to work through the regulatory issues and it ultimately required Verizon to tariff a service that few customers wanted and to remove "unlimited local directory" service from their package).

[5] General Order 96-A, Sections III-V; D.05-01-032, Appendix A.

[6] General Order 96-A, Section V; Order Granting Limited Rehearing of D.89-10-031 but denying rehearing of D.89-12-048, D.90-04-031, 36 CPUC 2d 276 (1990) (amending Ordering Paragraph 30 to D.89-10-031); Alternative Regulatory Frameworks for Local Exchange Carriers, D.94-09-065, 56 CPUC 2d 117, 263-264 (1994); D.05-01-035, Appendix A.

or product may be offered.[7] If the new service is protested by a competitor, a complex regulatory process is triggered, in which the ILEC can respond to the protest, the Commission staff drafts a Commission resolution, the resolution is subject to a public comment period, and must be publicly distributed 30 days in advance of a Commission meeting. If there are no additional complexities, the protest will commonly add at least four months (and as long as a year or two) of regulatory process delaying the introduction of a new service. One can see that competitors have much to gain by protesting any new ILEC service.

AT&T,[8] Frontier, SureWest, and Verizon argue that these price controls no longer serve a public interest. With the ending of telecommunications monopolies and the introduction of competition by the federal Telecommunications Act of 1996 and subsequent regulations, the ILECs no longer possess market power. Telecommunications customers can take their business to other carriers rather than wait for regulatory approvals. In addition, the ILECs have argued that the wireless industry's dramatic growth, the proliferation of new wireless services and technologies, and the dramatic reductions in wireless rates, have occurred under the FCC's policy of forbearing from price regulation. They argue that this offers a powerful example of how

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[7] See Comments of Emery G. Borsodi for SBC California at 34 (May 31, 2005).

[8] AT&T was known as Pacific Bell Telephone Company and SBC California in prior phases of this proceeding, and any company filing will be referenced in accordance with the company's name as it is listed on the title page of the filing. In the text of this decision, however, we will refer to the company only by the name it presently does business as (AT&T) when describing positions it has taken.

pricing freedoms can benefit both consumers and the telecommunications market.[9]

In response to these new market realities, the ILECs, therefore, recommended we adopt a new Uniform Regulatory Framework (URF). Specifically, they proposed reforms that would significantly expand their freedom to price telecommunications services, and would reduce the reporting, monitoring, and auditing apparatus that have evolved along with regulation of their prices over the decades.

In undertaking our review, we have found that, since the initial adoption of NRF, the statutory framework setting telecommunications policy in the nation and in California has evolved dramatically. A national decision to rely on competition whenever possible was made by Congress "in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies."[10] California statutes now endorse a reliance on open and competitive markets in the telecommunications industry unless the elimination of regulation would result in rates being set above "just and reasonable" levels.[11] Other California statutes further instruct us to use technologically and

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[9] See Comments of Emery G. Borsodi for SBC California at 34-35 (May 31, 2005).

[10] 47 U.S.C. pmbl.

[11] CAL. PUB. UTIL. CODE § 451 ("All charges demanded or received by any public utility, or by any two or more public utilities, for any product or commodity furnished or to be furnished or any service rendered or to be rendered shall be just and reasonable. Every unjust or unreasonable charge demanded or received for such product or commodity or service.").

competitively neutral measures in order to encourage the development of new technologies.

A central question in this proceeding, therefore, is whether ILECs possess market power in the current regulatory and market environment that limits the ability of the Commission to rely on market forces, rather than price controls, to produce "just and reasonable" rates consistent with a statutory framework that now dictates open markets, competitive and technological neutrality, and pricing freedoms. Before we address the issue at hand, we note that determining that carriers lack market power would not be a novel conclusion in telecommunications regulation. This Commission and the FCC have followed a path of relaxed regulation in the competitive long-distance wireline and wireless markets, so that currently neither this Commission nor the FCC regulate the prices of telecommunications services in these two markets. Further, many of the reforms we consider today have already been adopted in other states.[12] Thus, the regulatory road that we travel in this decision is consistent with direction provided by state and federal statutes, follows the same path traveled in long-distance and wireless markets, and tracks paths taken in the local telephone rate market by other forward-looking states.

In this decision, we recognize the importance of universal service public policy programs such as LifeLine that bring affordable telephone service to low income Californians. The Legislature and this Commission has made it clear that connecting as many Californians to the telephone system is important to enhance

[12] En Banc Tr. at 167 (testimony of Dr. Ed Rosenberg) (indicating twenty-one states already have engaged in telecommunications deregulation).

the value of this system and to serve important public safety goals. We explicitly acknowledge that we must continue to support these codified social policy programs. However, in places where social policies are not impacted, the law encourages us to rely on open markets and competition when seeking to achieve broad consumer benefits.

Our decision today results from a close adherence to the statutory guidance provided by California and federal law, from an acknowledgment of the regulatory accomplishments of the last ten years to open local communications markets, and from a recognition that market developments including increased competition from VoIP and wireless technologies preclude ILECs from the exercise of market power.

II. Background

This section reviews prior Commission rate regulation decisions. It then reviews parties' comments at workshops and hearings, and describes procedural decisions made in the URF proceeding.

A. History of the New Regulatory Framework

During the 1980s, the Commission recognized the need for California's telecommunications regulations to respond to significant changes in the telecommunications marketplace. Technological innovations and federal regulatory developments had spurred nascent competition in voice markets, and monopoly-style rules no longer seemed appropriate for certain services. Consequently, the Commission issued an Order Instituting Investigation (OII) to address pricing flexibility for services subject to competition; examine alternative approaches to ratemaking for basic service rates; and evaluate lifting the ban on intraLATA competition for message toll service and related services.[13] The Commission subsequently adopted a New Regulatory Framework (NRF) for SBC California, now known as AT&T, and Verizon in Decision (D.) 89-10-031. Several years later, the Commission applied NRF to mid-size ILECs.[14] These mid-size ILECs include Frontier and SureWest.[15]

The new incentive-based regulatory framework proved superior to the traditional rate-of-return (ROR) method of setting rates for the ILECs. The traditional ROR regulatory structure based rates on an ILEC's forecasted costs. An ILEC's past costs were used to predict these forecasted costs, so if an ILEC became more efficient and decreased its costs, the PUC would respond by decreasing the rates the ILEC could charge. ILECs, thus, had little incentive to decrease their long-run costs. In contrast, NRF created a profit-driven incentive for the ILECs to manage their operations in the most efficient manner possible. Resulting cost savings benefited both ratepayers and shareholders. NRF also

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[13] Re Alternative Regulatory Frameworks for Local Exchange Carriers, D.89-10-031, 33 CPUC 2d 43, 61 (1989).

[14] Seventeen wireline carriers, however, still are subject to traditional rate-of-return regulation. These carriers are smaller than most, and principally serve rural areas. Specifically, they include the following: Calaveras Telephone Company, California-Oregon Telephone Company, Citizens Telecommunications Company of the Golden State, Citizens Telecommunications Company of Tuolumne, Ducor Telephone Company, Evans Telephone Company, Foresthill Telephone Company, Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, The Ponderosa Telephone Company, Sierra Telephone Company, Siskiyou Telephone Company, Verizon West Coast Incorporated, The Volcano Telephone Company, and Winterhaven Telephone Company.

[15] The Commission authorized the NRF for Frontier and SureWest in Re Citizens Utilities Company of California, D.95-11-024, 62 CPUC 2d 244 (1995), and Re Roseville Telephone Company, D.96-12-074, 70 CPUC 2d 88 (1996), respectively.

supported rate stability and eliminated ongoing requirements imposed by traditional rate cases.

The centerpiece of NRF was the price-cap index that annually adjusted rates for individual services based on the following formula:

New Rate = Old Rate x (Inflation – Productivity +/- Z-Factors)

Inflation was measured by the gross national product price index (GNP-PI), and productivity was initially set at 4.5%. Z-Factors were other rate adjustments approved by the Commission.[16]

NRF included an earnings-sharing mechanism structured around a benchmark ROR of 13.00% and a ceiling ROR of 16.50%. SBC California kept 100% of its earnings up to the benchmark ROR, shared 50% of its earnings with ratepayers between the benchmark and ceiling RORs, and refunded to ratepayers 100% of its earnings above the ceiling ROR. Any refund of sharable earnings was to be implemented by reducing customers' rates through a surcredit.

Services were organized into three categories. Basic monopoly services were classified as Category I services.[17] Discretionary or partially competitive

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[16] Id. at 162. Z-Factors are a limited category of costs beyond the control of utility management; exogenous factors, whose effects were not reflected in the GNP-PI. Only specific types of costs were considered, such as, changes in federal and state tax laws to the extent they disproportionately affected ILECs more than other industries. Other examples included jurisdictional separations changes mandated by the FCC; changes to intraLATA toll pooling arrangements; and accounting procedures adopted by this Commission. This Commission, however, did not authorize Z-Factor treatment for all unforeseen or exogenous factors. We stated that normal costs of doing business (including costs of complying with existing regulatory requirements) or general economic conditions would not qualify as Z-Factor items. Id. at 60.

[17] Including switched access services. Rates are changed only with Commission approval.

services were classified as Category II services.[18] Fully competitive services were classified as Category III services.[19] The price for a Category I service was fixed, except for an annual adjustment equal to the price-cap index. The price for a Category II service could vary within a price floor and price ceiling. The price floor was increased annually by inflation, and the price ceiling was revised annually by the price-cap index. Prices for Category III services were provided with more flexibility..

D.89-10-031 also established a triennial review cycle for NRF. The first triennial review resulted in several significant changes to NRF. In D.93-09-038, the Commission permitted Verizon to keep all of its earnings up to the ceiling ROR, reduced Verizon's rates by $53 million, and increased the productivity factor in Verizon's price-cap index. In D.94-06-011, the Commission increased the productivity factor in SBC California's price-cap index; replaced GNP-PI in SBC California's price-cap index with the gross domestic product price index; reduced SBC California's benchmark ROR and ceiling ROR to 11.5% and 15%, respectively; and allowed SBC California to retain 70% of its earnings above the ceiling ROR, with the remaining 30% refunded to ratepayers.

In the second triennial review of NRF, the Commission, in D.95-12-052, set the productivity factor equal to the inflation factor. This decision effectively suspended the price-cap index except for Z-Factor adjustments. At the same time, the Commission capped the prices of both SBC California's and Verizon's Category I and II services at their existing rates. Both the suspension of the

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[18] I.e., custom calling, vertical features.

[19] Examples include enhanced services and inside wiring.

formula and the price caps remained in place, and were listed as items that would be reevaluated in the next triennial review.[20]

In the third triennial review, the Commission, in D.98-10-026, suspended the earnings-sharing mechanism, continued the suspension of the price-cap index, phased out existing and new Z-Factor adjustments, and replaced Z-Factor adjustments with a streamlined advice letter process for a limited set of exogenous costs and revenues.[21] In that decision, the Commission also placed rate caps on residential services.[22]

The fourth triennial review was a multi-phased proceeding. D.02-10-020 concluded Phase 1 of the review, and addressed 144 factual issues that emerged from the Division of Ratepayer Advocates' (DRA)[23] audit of Verizon's NRF monitoring reports and accounting procedures. The issues examined in Phase 1 included the following: whether Verizon and its affiliates were abiding by the Commission's rules for affiliate transactions; whether they had properly tracked and allocated costs for non-regulated activities; and whether the existing non-

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20 Re Incentive-Based Regulatory Framework for Local Exchange Carriers, D.95-12-052, 63 CPUC 2d 377, 381 (1995).

21 The reporting of earnings continued; annual depreciation reviews, however, were permanently eliminated.

22 Re Third Triennial Review of the Regulatory Framework Adopted for GTE California Inc. and Pacific Bell, D.98-10-026, 82 CPUC 2d 335, 376-377 (1998).

23 DRA previously was known as the Office of Ratepayer Advocates, and any filing will be referenced in accordance with the entity's name as it is listed on the title page of the filing. In the text of this decision, however, we will refer to the organization only by its present-day name (DRA) when describing positions it has taken in this proceeding.

structural safeguards offered adequate protections. The parties settled most of the issues raised in the audit report.

The settlement required Verizon to implement new procedures to ensure proper regulatory accounting for affiliate transactions and unregulated activities, and to submit restated financial reports reflecting many of the financial adjustments identified by DRA. The parties, however, could not agree on the ratemaking treatment for DRA's suggested financial adjustments. Ultimately, the Commission declined to adopt certain rate reductions, and rejected the proposal to revise the affiliate transaction rules. Instead, in D.02-10-020, the Commission directed DRA to conduct another audit of Verizon and authorized it to hire certified public accountants and technical experts to perform the audit.

In D.04-02-063, Phase 2A of the fourth triennial review, the Commission addressed four of the seventy-two findings that came out of a SBC California audit conducted by the Commission's Telecommunications Division (TD). These four issues pertained to (1) pensions; (2) post-retirement benefits other than pensions (PBOPs); (3) write down of plant assets; and (4) income taxes. The Commission held that SBC California properly reported its expenses for pensions, depreciation, and the write-off of its PBOP regulatory asset, but misstated expenses reported for certain other PBOP costs and income taxes by $119.1 million. The Commission also determined that SBC California improperly withdrew $180 million from one of its PBOP trust funds in 1999: SBC California was ordered to return the money, with interest, to the trust fund.[24]

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[24] Interim Opinion Regarding Selected Issues Related to the Audit of SBC Pacific Bell Telephone Company, D.04-02-063, 2004 Cal. PUC LEXIS 55 at 65 (2004).

In D.04-09-061, Phase 2B of the review, the Commission examined the remaining sixty-eight findings. It held that a number of audit determinations were justified, and that SBC California overreported expenses in some instances. While there were findings of accounting errors and misinterpretations of Commission policy, the Commission did not find SBC California liable for any fraudulent action. The Commission decision required SBC California to remedy the company's earnings reporting for 1999; the changes ordered, however, did not result in ratepayer sharing for that year.[25] Finally, as required, SBC California prepared schedules that identified each of the detected errors and demonstrated that it had corrected or would properly correct the earnings reporting, consistent with Generally Accepted Accounting Principles.[26] Thus, despite years of litigation and controversy, the contentious audit produced no changes that affected rates in any year covered by the review.

On October 15, 2004, the Assigned Commissioner[27] of the fourth triennial review, set forth the scope of Phases 3A and 3B. The scoping ruling provided parties with the opportunity to submit comments regarding whether and how the issues of Phases 3A and 3B should be revised in light of technological, regulatory, and market changes that have occurred since the phases were initially established. A number of parties submitted comments. The initiation and progress of this proceeding (Rulemaking 05-04-005) have enabled us to close these final phases, which otherwise would have been anachronisms.

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[25] Interim Opinion Regarding Phase 2B Audit Issues, D.04-09-061, 2004 Cal. PUC LEXIS 477 at 127 (2004).

[26] Id. at 165.

[27] The Assigned Commissioner at that time was Commissioner Susan P. Kennedy.

The triennial review history for the mid-size ILECs is far shorter than that of AT&T and Verizon. In Frontier's first triennial review, the Commission, in D.99-04-003, assessed the company's service quality experience both in general and in reference to the Service Quality Assurance Mechanism (SQAM)[28] and Improvements. Frontier's second triennial review included a settlement agreement that the Commission approved in D.00-03-040, which modified reporting requirements, eliminated SQAM and depreciation filings, and continued the suspension of the price-cap index. The Commission approved SureWest's first triennial review in D.01-06-077, and adopted a revised settlement in D.04-11-032, which modified the framework until 2010. For both companies, the structure of the regulatory framework was generally aligned with that in place for SBC California and Verizon at that time.

B. Order Instituting Rulemaking for a Uniform Regulatory Framework

On April 14, 2005, the Commission instituted this rulemaking to assess and revise the rate regulation of large and mid-size ILECs in California.[29] The primary purpose of the proceeding was to develop a uniform regulatory framework for the ILECs, to the extent that such a framework would be feasible and in the public interest. The Order Instituting Rulemaking (OIR) listed, described, and appended, along with the elements of a hypothetical Uniform Regulatory Framework, specific issues to be considered within the proceeding.[30]

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[28] SQAM is a program evaluating service quality.

[29] See note 14 for a list of small ILECs excluded from this review.

[30] See OIR 05-04-005.

C. Filings of the Parties

Parties to the proceeding filed comments pursuant to the OIR in 2005. On May 31 of last year, sixteen parties filed opening comments in the rulemaking:[31] the two largest ILECs filed newly proposed "frameworks;" DRA and The Utility Reform Network (TURN) assessed and proposed specific changes to the existing framework; and Frontier and SureWest proposed frameworks similar to the one set forth in the OIR's Appendix A, Issue 10. The other parties' comments offered more limited evaluations and suggestions. On September 2, 2005, twelve parties filed reply comments.[32]

Parties filed briefs on the proceeding in 2006. On March 6, 2006, thirteen parties submitted opening briefs on topics addressed in this phase of the proceeding, including the issue of the level of competition.[33] The level of competition was further examined during a evidentiary hearing lasting four

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[31] DRA, The Utility Reform Network (TURN), SBC California, Verizon California, SureWest Telephone, Frontier, Cox California Telcom, LLC DBA Cox Communications; Department of Defense and all other Federal Agencies (collectively, DOD), Disability Rights Advocates, XO Communications (XO); Nextel of California (Nextel), California Cable and Telecommunications Association (CCTA); Pac-West Telecom and Level 3 Communications; MCI, Inc. and California Small Business Roundtable and California Small Business Association (collectively, CSB).

[32] DRA; TURN; SBC California; Verizon California; SureWest Telephone; Frontier; CCTA; DOD; Time Warner Telecom of California, LP (Time Warner); Cox Communications; The Greenlining Institute (8/12/05) (Greenlining); Disability Rights Advocates; and MCI.

[33] These parties included the following: DRA; TURN; SBC California; Verizon California; SureWest Telephone; Frontier; Cox Communications; CCTA; DOD; Time Warner; Greenlining; California Payphone Association; and Disabled Rights Advocates.

days, from January 30 to February 2, 2006. On March 24, 2006, eleven parties filed reply briefs.[34]

D. Workshops

Two workshops were held during the URF proceeding. This section describes the parties' participation and how the Commission responded to various issues raised in the workshops.

1. First Workshop: Procedural Issues

On June 3, 2005, a one-day session addressed pending requests for changes in the schedule; parties' participation in the planned June 27, 2005 en banc informational hearing; and parties' questions and concerns about the structure of the OIR. Some parties asked whether a more definite scoping memo would be issued, because it would help them better determine how they should advocate for evidentiary hearings.[35] Several parties also urged the Commission to adjust the schedule in consideration of pending merger proceedings for the two largest California ILECs, or at the least, extend the deadline for reply comments in this proceeding.[36]

Issues regarding the proceeding schedule and need for evidentiary hearings sparked significant debate among proceeding participants. On the one hand, the ILECs argued that it was important to keep the proceeding schedule on track. They stated there was an urgent need for regulatory reform, that reform

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[34] Neither CCTA nor California Payphone Association filed reply briefs.

[35] Nextel, WS-1 Tr. at 6; CCTA, id.. at 12; Time Warner, id. at 14; CALTEL,id. at 30.

[36] Pac-West and Level 3, id. at 16; Cox Communications, id. at 18-21; Disability Rights Advocates, id. at 23; DRA, id. at 25-27, 35-36; TURN, id. at 29-30, 34; CALTEL, id. at 31; XO, id. at 32-33, and DOD, id. at 33.

would bring benefits to consumers, and that parties already had ample time to consider issues raised in the OIR [37] On the other hand, Disability Rights Advocates (DisabRA), DRA, and TURN[38] urged the Commission to include public participation hearings in the ultimate procedural schedule. They noted that "in the original NRF proceeding there were 13 public participation hearings held throughout the state."[39] TURN also called for convening of further technical workshops, where parties could discuss and work through the details of various proposed frameworks.[40]

The preliminary layout for the en banc hearing was outlined at the conclusion of the workshop. Some parties indicated that they would prefer not to participate actively in the en banc hearing,[41] so the Commission invited academic experts and non-parties to participate in the hearing instead.

Subsequent to the first workshop, the Assigned Commissioner and the Administrative Law Judge issued a memo that resolved scoping ambiguities

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37 SBC California, id. at 9-10; SureWest and Frontier, id. at 15; Verizon California, WS-1, id. at 21-23.

38 Disability Rights Advocates, id. at 24; DRA, id. at 26, 28-29; TURN, id. at 30.

39 Id. at 30.

40 Id. at 30.

41 Id. at 50.

identified in the workshop.[42] This scoping memo led to the withdrawal of parties whose interests were beyond the scope of this phase of the URF proceeding.[43]

2. Second Workshop: Presentation of Parties' Proposals

During the second workshop, from September 20-22, 2005, the parties that submitted URF framework proposals gave presentations on their proposals, and then answered any questions elicited by either their written comments or their oral presentation. Parties also were encouraged to meet informally and identify the issues on which they agreed and disagreed.

Delivering the initial presentation, DRA argued that AT&T, Frontier, SureWest, and Verizon should continue to be subject to price caps set at the existing statewide average prices.[44] DRA stated that it was "not convinced that there is enough competition out there to ensure that every California consumer has safe, reliable, affordable primary line service to their home."[45] DRA, TD, CCTA, SureWest, TURN, Disability Rights Advocates,[46] AT&T, Cox California

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[42] Scoping Memo (issued Aug. 4, 2005).

[43] Nextel of California, XO Communication, California Association of Competitive Telecommunications Companies (CALTEL), PacWest, and Level 3 filed opening comments, but none filed reply comments (or briefs). Nextel formally withdrew from Phase 1of the case on August 12, 2005. Level 3 filed a notice of withdrawal from Phase 1 on August 25, 2005. While they were not active in the remainder of Phase 1, no other party listed above formally withdrew from Phase 1 or the proceeding.

[44] WS-2, Tr. at 55.

[45] Id. at 55.

[46] For Disability Rights Advocates, Dimitri Belser of the Center from Accessible Technology.

Telecom (Cox), Frontier, and Time Warner Telecommunication of California (Time Warner) questioned DRA on its presentation and its comments.[47]

In the second presentation, Cox maintained it agreed with a number of elements of the ILECs' proposals. These elements included the following: (i) the elimination of earnings sharing; (ii) the streamlining of the reports process, and how there should be equalization of reporting burdens; (iii) less review of sensitive, proprietary data; and (iv) standardization of notice requirements with CLECs.[48] Cox added that differences between its position and that of other parties "aren't necessarily as wide as we might think they are."[49] According to Cox, differences with the ILECs included the need for price floors, restrictions on promotions for basic service, and time limits on certain promotions. TD, DRA, TURN, SureWest, and AT&T asked questions after the presentation.[50]

AT&T, delivering the third presentation, set forth fifteen elements of its URF proposal. These elements included i) the elimination of earnings regulation; ii) full pricing flexibility for residential and business services, with an exception for primary-line basic residential service; iii) a one-day advice letter process; and iv) no restrictions on promotions.[51] Like Cox, it observed that "there are many

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[47] Id. at 62, 64-70, 71, 72-78, 86, 91, 93, 79-80, 82, 84-85, 89-91, 93-99, 105-106, 106-111, and 112-114.

[48] Id. at 120-121.

[49] Id. at 116-117.

[50] Id. 125, 126-127, 128, 129-132, and 134.

[51] Id. at 140-147.

items in which there is at least substantial agreement. . . ."[52] TD, DRA, Cox, CCTA, and TURN asked questions during the AT&T presentation..[53]

On September 21, 2005, Verizon gave the fourth presentation in the workshop, and reviewed areas of agreement and disagreement in parties' proposals. It emphasized that that there were many areas of agreement in AT&T's, DRA's, and Verizon's proposals.[54] Yet Verizon noted four areas of significant disagreement: (1) "the 'basic' residential services that are subject to a cap for some amount of time"; (2) the definition of basic business services that will be subject to the cap; (3) the length of the caps; and (4) revenue neutrality.[55]

Deborah Aron, Verizon's economic expert, described and explained the reasoning behind Verizon's disagreements with other parties. She stated that the "rate structures in place today are the legacy of a long history of regulation" and are "not benign."[56] Aron maintained that the rate caps unduly restrained ILECs' ability to price their services in a manner consistent with the "very substantial inter- and intramodal competition in the marketplace today."[57] DisabRA, TURN,

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52 Id. at 147.

53 Id. at 148-154, 156-161, and 163-166.

54 WS-3, Tr. at 173.

55 Id. at 175-180.

56 Id. at 182.

57 Id. at 182.

DRA, Cox, CCTA, AT&T, and Time Warner asked questions after Verizon's presentation.[58]

Delivering the next presentation, MCI, Inc. (MCI) summarized its framework proposal as "driven by and towards technology-neutral regulation."[59] Their proposal included, among other items, i) the elimination of the entry certification process and replacement with a registration process; ii) reform of merger and acquisition requirements; iii) elimination of the retail tariff process; iv) elimination of monitoring and reporting requirements, v) elimination of service quality standards and rules unnecessary for consumer protection or public health and safety; and vi) maintaining the Commission's existing role with regards to wholesale regulation.[60]

DisabRA followed MCI and submitted comments it had compiled from members of the disabled community. Hoping to sensitize the Commission and parties to their concerns, DisabRA stated that "no matter what framework is in place . . , the Commission needs to make sure that people with disabilities continue to have access to affordable, accessible and high quality . . . products and services that most people would think of as . . . something other than basic services but that are certainly necessities to people with disabilities."[61] DisabRA further maintained that "having incentives for making a product more accessible

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[58] Id. at 183-185, 185-186, 187-193, 194, 195-199, 200, 203-204, 207, 209, 210, 211-213, 214-216.

[59] Id. at 227.

[60] Id. at 228-230.

[61] Id. at 240.

would be a really good way" to encourage development of products that are more usable by all consumers.[62] TD, DRA, and AT&T asked questions and discussed aspects of DisabRA's presentation.[63]

TURN focused its presentation on market power, which it asserted was the "the crux" of this proceeding."[64] TURN stated that its proposal was based upon its determination of "where market forces were operative, and where they were not."[65] This proposal included the following: i) continued regulation of basic exchange services for residences and businesses; ii) some pricing flexibility for other services; iii) continued monitoring of subscription rates, price changes, service quality, and competition status; and iv) retaining certain elements of earnings sharing.[66] TURN reiterated its call for public hearings.[67] Noting that Frontier and SureWest faced no facilities-based competition, TURN further maintained that the Commission should apply the new regulatory framework solely to AT&T and Verizon. TURN, with respect to AT&T and Verizon, conceded that "there is at least some evidence that market forces have advanced from the pure monopoly level."[68] CCTA, Verizon, AT&T, SureWest, Frontier,

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[62] Id.

[63] Id. at 250-251, 255-257, 258-259.

[64] Id.

[65] Id. at 265.

[66] Id. at 262-265, 282-284, 284-285.

[67] Id. at 263-264, 264-265.

[68] Id. at 271.

DRA, and Disability Rights Advocates commented and asked questions about statements made in TURN's presentation.[69]

In making its workshop presentation, SureWest described its plan as "very similar to what [AT&T] has presented. Some parts of that are also [similar to] what Verizon submitted."[70] SureWest, however, focused on the differences between its proposal and AT&T's in order to clarify its position. SureWest questioned the need for filing contracts with the Commission. SureWest's proposal also included the elimination, or application to all providers, of audit requirements; and the elimination of NRF monitoring reports and processes.[71] After the presentation, Cox and CALTEL commented that they too supported the elimination of contract filing[72]

Frontier, which followed SureWest, focused on five areas of its URF proposal: (i) the basic service definition; (ii) a two-year phase-in period; (iii) movement toward a regime where services are detariffed; (iv) rate rebalancing; and (v) deaveraging that would be appropriate under a uniform regulatory framework. Frontier noted that apart from encouraging the Commission to move more toward detariffing services, the other areas

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[69] Id. at 285-287, 288-289, 289-290, 291-292, 293, 299-301, 302, 304, 306-309.

[70] Id. at 310-311.

[71] Id. at 311-314.

[72] Id. at 318.

emphasized were similar to those set forth in AT&T's and Verizon's plans.[73] CALTEL asked a question after Frontier's presentation.[74]

Greenlining followed Frontier with a brief statement, informing parties that it would be actively participating in the proceeding and that it would primarily focus on "closing the Digital Divide, and developing a strategy designed to ensure . . . affordable and accessible quality services for low-income and minority communities."[75] Greenlining added that it strongly supported holding evidentiary hearings.[76]

The Department of Defense/Federal Executive Agencies (DOD/FEA) made the final presentation of the workshop. Their expert, Harry Gildae, described their plan as similar to DRA's "in many ways."[77] Specifically, DOD/FEA proposed that "the Commission continue to maintain pricing surveillance for basic residence and business services, with pricing flexibility for all other services."[78] The principal difference Gildae pointed out between DOD/FEA's proposal and DRA's is that DOD/FEA recommends a revenue cap in place of a price cap for the aggregate of the basic residence and business services.[79]

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[73] Id. at 314-317.

[74] Id. at 319.

[75] Id. at 321.

[76] Id.

[77] Id. at 323.

[78] Id.

[79] Id.

While it did not submit a plan, Time Warner also made a brief statement at the workshop. Its proposal included maintaining price floors for business service.[80] Time Warner also indicated that it was interested in following the debate on intermodal competition.[81] TimeWarner expressed concern that the debate on intermodal competition was not focused enough on the business market, which it characterized as "a fiber cable market into the office space where people still want wireline systems of some sort."[82] TimeWarner added that this market was less competitive and warranted more regulatory consideration.[83]

On the third and final day of the workshop, the parties discussed areas of agreement and disagreement within and outside of their various proposals. Procedural issues were the subject of much of these discussions. Cox reiterated its support for evidentiary hearings,[84] while AT&T and Verizon continued to argue that evidentiary hearings were unnecessary.[85] Parties also discussed engaging in informal discussions in the future. DRA recommended the parties get together and begin "at least partial settlement negotiations" to see if they could develop a consensus and pare down the list of areas where there remains

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80 Id. at 331.

81 Id. at 328.

82 Id.

83 Id.

84 WS-4 Tr. at 338-346.

85 Id. at 348-350, 353-354.

disagreement.[86] Most parties said they were uncomfortable with characterizing the upcoming discussion as "settlement negotiations;" instead they agreed that they would work together to develop "a conglomeration of everybody's different proposals into a series of either agreements on subjects, or disagreements on subjects."[87]

After the workshop, parties met for regular sessions for a period of time in order to generate a document that would accurately reflect the URF proposal agreements and disagreements. DRA then submitted a matrix entitled Comparison of URF Proposals on October 13, 2005. All parties to this proceeding endorsed the matrix.

E. En Banc Informational Hearing

On June 27, 2005, the Commission convened a daylong informational hearing to help it determine what changes are needed in California telecommunications regulation.[88] The hearing was designed to perform two primary functions: (i) to provide the Commission with a conceptual framework for thinking about issues central to regulatory reform , and (ii) to show the Commission how California businesses, workers, and consumers are affected by the state's telecommunications industry.

The Assigned Commissioner presided over two sessions of several panels comprised of industry, financial, and regulatory experts; academics; consumer

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[86] Id. at 362.

[87] Id. at 370.

[88] President Michael Peevey was attending merger hearings in Southern California, and was necessarily absent. Commissioners John Bohn, Geoffrey Brown, Dian Grueneich, and Susan P. Kennedy were in attendance.

representatives; and special interest groups. The morning session's topic, "The Impact of Regulation and Regulatory Reform on Regulated Enterprises and Telecommunications Companies," described the contours of the national regulatory framework and status and expected developments of telecommunications industry.

The first two speakers, Dr. John M. De Figueiredo[89] and Dr. Tom Hazlett,[90] gave economic and historical accounts of how different regulatory frameworks have affected various U.S. industries. They both concluded that the main drivers of reform were technological advances and economic development, and a regulatory framework should be designed to encourage such advances and development. DeFigueiredo emphasized that successful deregulatory reform required proper timing; knowledge about marketplace activity; and competition and speedy implementation of deregulatory activity. Hazlett commented that for deregulated activity to be successful, facilities-based investment was necessary for long-term consumer welfare and meaningful competition.

Dr. Yale Braunstein,[91] the third speaker, advised the Commission that regulators should develop and enforce rules so that consumers, both residential and business, understand what they are buying and how much they will have to

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89 Research Fellow in Law and Public Policy at the Woodrow Wilson School, Princeton University.

90 Adjunct Professor of Business and Public Policy at the Wharton School and Senior Fellow at the Manhattan Institute of Policy Research, University of Pennsylvania.

91 Professor, School of Information Management and Systems, University of California at Berkeley (En Banc Tr. at 57-67).

pay.[92] He also recommended that policymakers recognize that the telecommunications and information needs of the public are changing and that broadband is becoming a necessity.[93]

Dr. Ed Rosenberg,[94] the fourth speaker, reviewed current state telecommunications deregulatory initiatives.[95] Looking at approximately twenty-one states, Rosenberg found that the scope of deregulation varied from state to state,[96] but overall there was a general national trend toward "less regulation of services that are potentially competitive, and in markets where there's more competition, more price flexibility for the companies, more ability to offer bundles and packages."[97] He added that none of these reforms had been in effect long enough to gauge their effectiveness, either positively or negatively.

The Commission's Telecommunications Division Director Jack Leutza closed the first session with a summary of telecommunications regulation in California. He also described the challenges of responding to changes in the telecommunications marketplace, while maintaining a commitment to the mission of protection, access, quality service, and reasonable cost for the consumer.

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[92] Id. at 66.

[93] Id. at 66-67.

[94] Senior Economist at the National Regulatory Research Institute, Ohio State University.

[95] Id. at 81-90.

[96] In what was covered or left under regulatory control.

[97] Id. at 167.

In the afternoon, Commissioners heard from three panels. Members of these panels were asked to address the following two questions:

1. How do California's telecommunications regulations affect your constituency?
2. Where should California go from here in regulation to advance the public interest?[98]

Panelists in the afternoon included representatives from consumer groups and information technology companies.

The members of the first panel – comprised of representatives from several consumer groups,[99] the disabled community,[100] and the minority small-business community[101] – called for targeted regulation. They urged the Commission to maintain its oversight role and focus on consumer protection. In particular, the first panelists recommended that the Commission sponsor telecommunications consumer education programs;[102] continue price regulation of basic services;[103] and safeguard accessibility rights of disabled persons.[104]

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[98] Id. at 100.

[99] Robert Gnaizda, General Counsel and Policy Director of Greenlining Institute; Jim Conran, President of Consumer First; Ken McEldowney, Executive Director, Consumer Action. Id. at 108-110.

[100] Deborah Kaplan, Former Executive Director of World Institute on Disabilities and a private consultant.

[101] Aubry Stone, President and CEO of the California Black Chamber of Commerce. Id. at 114-117.

[102] Id. at 122.

[103] Id. at 121.

[104] Id. at 136.

The second panel was comprised of California business technology experts[105] who discussed how regulatory policies impact investment in telecommunications infrastructure. According to the panelists, the deregulated federal framework for Internet Protocol (IP) services reflects the difference between today's competitive communications environment and the prior communications environment, where voice service was limited to the Public Switched Telephone Network (PSTN) and regulations strictly controlled consumer choices.[106] While acknowledging that issues like 911 and Universal Service require special consideration, the experts advocated a deregulatory approach.[107] Some encouraged the streamlining of certain rights-of-way decisions,[108] and, with respect to Internet-based services, that the Commission "continue [its] policies of regulatory restraint under the auspices of a uniform federal policy."[109]

Richard Siderman, Standard and Poor's Managing Director of Corporate and Government Ratings, was the sole speaker on the final panel of the day. He presented an overview of significant financial trends in the telecommunications industry and a financial community perspective on the effects of regulation. In

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[105] The panelists were as follows: Rodney Vidal, Vice President, Level 3 Communications Group (Id. at 140-164); James Hawley, General Counsel and Director, TechNet Outreach (Id. at 164-171); Jeffrey Campbell, Director of Technology and Communication Policy, Cisco (Id. at 172-180).

[106] Id. at 141-145.

[107] Id. at 170, 179, 180.

[108] Id. at 169-170.

[109] Id. at 169.

the past, with ROR regulation, Siderman said telephone companies "traded limits on profits for safety."[110] The ratings firms considered such companies a solid investment.[111] But recognizing the change in regulation in 2000, Standard and Poor's implemented a new rating policy, which no longer accepts "regulatory separation."[112] Now Standard and Poor's considers regulated telephone companies to be a riskier investment, no longer protected by the regulators. Finally, Siderman's assessment of credit prospects for telephone companies was generally negative.[113] He explained that telephone companies are losing customers to wireless and cable companies, appear to be facing more pressure on prices and margins, and are confronting new competition from Voice over Internet Protocol (VoIP) providers.[114] In these uncertain times, Siderman concluded that investors will seek clarity and predictability from a state regulatory framework.[115]

F. Hearings

On December 16, 2005, the Commission President, the Assigned Commissioner, and ALJ issued a joint ruling setting three days of evidentiary hearings (EHs) for the end of January 2006. The purpose of the EHs was to allow the parties an opportunity to go beyond their workshop discussion regarding the

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[110] Id. at 196.

[111] Id. at 196.

[112] Id. at 197.

[113] Id. at 199.

[114] Id. at 199.

[115] Id. at 203.

existing level of competition in the statewide telecommunications market. Although no party identified a material factual dispute pertaining to the data underlying parties' competition analyses, a review of the framework proposals, comments, and workshop transcripts revealed that there were clear differences of interpretation of such data.

EHs took place from January 30 through February 2, 2006.[116] AT&T, Verizon, SureWest, Frontier, DRA, TURN, and DOD/FEA presented witnesses for cross-examination, and most of the active parties in the proceeding participated in the EHs.[117] The new Assigned Commissioner was in attendance for a majority of the EHs.[118]

On the last day of the EHs, the Assigned Commissioner gave each party the opportunity to present a five-minute oral presentation summarizing the party's framework proposal and/or position in the URF proceeding. Eleven parties delivered summary presentations.[119]

III. Overview of Statutory Goals

In addition to striving to meet the goals adopted in the OIR, a new regulatory framework must comply with state and federal statutes and should

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[116] An additional day was added during the hearings.

[117] The participants included AT&T, Verizon, SureWest, Frontier, DRA, TURN, DisabRA, and DOD/FEA.

[118] On January 1, 2006, Commissioner Kennedy resigned from the Commission. Commissioner Rachelle Chong replaced Commissioner Kennedy as Assigned Commissioner to the URF proceeding on January 19, 2006.

[119] The parties that delivered presentations were, in order, AT&T, Verizon, SureWest, Frontier, DRA, TURN, DOD/FEA, Greenlining, Cox, CCTA, and Time Warner Telecom.

endeavor to meet the policy goals and conform to the policy preferences incorporated into statutes. This section provides a brief overview of the major telecommunications requirements and policies incorporated into statutes that will guide our modification of telecommunications regulations.

A. State and Federal Statutes Encourage Reliance on Competition to Promote Broad Consumer Interests

California statutes express a clear desire to support competitive markets.[120] State policies for telecommunications, in particular, are laid out in Public Utilities Code § 709. These policies are as follows:

> (a) To continue our universal service commitment by assuring the continued affordability and widespread availability of high-quality telecommunications services to all Californians.
>
> (b) To focus efforts on providing educational institutions, health care institutions, community-based organizations, and governmental institutions with access to advanced telecommunications services in recognition of their economic and societal impact.
>
> (c) To encourage the development and deployment of new technologies and the equitable provision of services in a way that efficiently meets consumer need and encourages the ubiquitous availability of a wide choice of state-of-the-art services.

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[120] The California Public Utilities Code states that "the essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, reasonable and just prices, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured." CAL. PUB. UTIL. CODE § 8281(a).

(d) To assist in bridging the "digital divide" by encouraging expanded access to state-of-the-art technologies for rural, inner-city, low-income, and disabled Californians.

(e) To promote economic growth, job creation, and the substantial social benefits that will result from the rapid implementation of advanced information and communications technologies by adequate long-term investment in the necessary infrastructure.

(f) To promote lower prices, broader consumer choice, and avoidance of anticompetitive conduct.

(g) To remove the barriers to open and competitive markets and promote fair product and price competition in a way that encourages greater efficiency, lower prices, and more consumer choice.

(h) To encourage fair treatment of consumers through provision of sufficient information for making informed choices, establishment of reasonable service quality standards, and establishment of processes for equitable resolution of billing and service problems.[121]

This detailed list of state policy objectives sets the goals for a telecommunications regulatory reform proceeding, such as this one.

In the same Public Utilities Code section that lists state goals for telecommunications, the California Legislature also provides direct guidance on the means regulators should employ to achieve these goals. Specifically, Public Utilities Code § 709.5 endorses a reliance on competitive markets to achieve these goals. According to the Public Utilities Code, "[i]t is the intent of the Legislature that all telecommunications markets subject to commission jurisdiction be opened to competition not later than January 1, 1997. The commission shall take

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[121] CAL. PUB. UTIL. CODE § 709.

steps to ensure that competition in telecommunications markets is fair and that the state's universal service policy is observed."[122]

Consistent with the Legislature's intent, the Commission, whenever possible, has relied on competition as a means to ensure that rates are "just and reasonable."[123] For example, in reviewing whether to grant AT&T[124] pricing flexibility for long distance services, the Commission concluded that "competition from the other IECs should ensure reasonable prices in these markets. If AT&T-C prices its services too high or if its service quality deteriorates, customers will have the incentive to switch to a lower-priced or better-quality carrier."[125]

Reliance on competition in telecommunications markets also is found in national laws and policies set by the FCC. The overarching purpose of the

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122 CAL. PUB. UTIL. CODE § 709.5(a).

123 CAL. PUB. UTIL. CODE § 451 ("All charges demanded or received by any public utility, or by any two or more public utilities, for any product or commodity furnished or to be furnished or any service rendered or to be rendered shall be just and reasonable. Every unjust or unreasonable charge demanded or received for such product or commodity or service.").

124 This reference is to AT&T California, the long-distance carrier that subsequently merged with SBC California.

125 <u>In the Matter of the Application of AT&T Communications of California, Inc. for Additional Regulatory Flexibility</u>, D.93-02-010, 48 CPUC 2d 31 (1993). Similarly, in setting Zone of Rate Freedom for airport vans, the Commission commonly concludes that the "competitive transportation services will result in reasonable rates when considered with the ZORF authorized below." <u>Application of Sacramento Metro Shuttle (PSC 1438) to redefine its zones and establish a Zone of Rate Freedom and individual fares for passenger stage service between zones in authorized service territory and Sacramento Metropolitan Airport</u>, 92-10-016, 45 CPUC 2d 683 (1992).

federal Telecommunications Act of 1996, as indicated by its title, is "[t]o promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies."[126] The "deregulatory purpose"[127] of this Act has been recognized by the FCC,[128] federal courts,[129] and state courts.[130]

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[126] 47 U.S.C. pmbl..

[127] Qwest Communs., Inc. v. City of Berkeley, 433 F.3d 1253, 1255 (9th Cir. 2006).

[128] In the Matter of Implementation of the Local Competition Provision in the Telecommunications Act of 1996, 11 FCC Rcd 15499, ¶ 1 (1996) (First Report and Order) ("In the new regulatory regime, [the FCC] and the states remove the outdated barriers that protect monopolies from competition and affirmatively promote efficient competition using tools forged by Congress.").

[129] See, e.g., Qwest, 433 F.3d at 1255 (declaring the purpose of the Telecommunications Act of 1996 "was to reduce regulation of telecommunications providers by creating a 'procompetitive, deregulatory national policy framework'") (quoting H.R. Rep. No. 104-458 (1996) (Conf. Rep.)).

[130] See, e.g., Wash. Indep. Tel. Ass'n v. Wash. Utils. & Transp. Comm'n, 149 Wn.2d 17, 20 (Wash. 2003) ("Updating the Communications Act of 1934 (the 1934 Act), the Telecommunications Act of 1996 aims to reduce regulation and enhance competition: 'This law represents a vision of a telecommunications marketplace where the flexibility and innovation of competition replaces the heavy hand of regulation. It is based on the premise that technological changes will permit a flourishing of telecommunications carriers, engaged in head-to-head competition, resulting in a multitude of communications carriers and programmers being made available to the American consumer.'") (quoting Michael I. Meyerson, *Ideas of the Marketplace: A Guide to the 1996 Telecommunications Act*, 49 FED. COMM. L.J. 251, 252 (1997)).

Moreover, while it curtails state regulatory authority in some areas,[131] the Telecommunications Act of 1996 grants states broad powers to adopt rules that promote competition:

> Nothing . . . precludes a State from imposing requirements on a telecommunications carrier for intrastate services that are necessary to further competition in the provision of telephone exchange service or exchange access, as long as the State's requirements are not inconsistent with this part [47 USCS §§ 251 et seq.] or the Commission's regulations to implement this part. . . .[132]

Thus, the Telecommunications Act of 1996 endorses state legislation that relies on competition as the preferred means of ensuring consumer benefits in telecommunications markets.

In summary, state and federal telecommunications policies direct us to promote and rely upon competitive markets whenever possible. We, therefore, should seek to ensure that the regulatory framework that we adopt in this proceeding enables further competition in the telecommunications marketplace.

B. State and Federal Statutes Instruct Regulators to Adopt Competitively and Technologically Neutral Policies that Promote the Development of a Wide Variety of New Technologies and Services

California statutes also call for regulators to adopt technologically and competitively neutral policies that encourage increased access to and usage of advanced telecommunication services. Among the telecommunications policies

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131 See, e.g., 47 U.S.C. § 332 (preempting states from regulating entry and rates of wireless carriers); 47 U.S.C. § 276 (preempting state regulation of payphone providers).

132 47 U.S.C. § 261.

enumerated in the Public Utilities Code, the California Legislature declares that the state shall "encourage the development and deployment of new technologies . . . in a way that efficiently meets consumer need and encourages the ubiquitous availability of a wide choice of state-of-the-art services."[133]

In an effort to bring advanced telecommunication services to all Californians, the Legislature orders the Commission "consider . . . [h]ow to encourage the timely and economic development of an advanced public communications infrastructure, which may include a variety of competitive providers."[134] It declares that any new policies adopted as a result of this review should seek to achieve the following goals:

> (1) To provide all citizens and businesses with access to the widest possible array of advanced communications services.
>
> (2) To provide the state's educational and health care institutions with access to advanced communications services.
>
> (3) To ensure cost-effective deployment of technology so as to protect ratepayers' interests and the affordability of telecommunications services.[135]

Here too the Public Utilities Code establishes that regulatory policies should encourage access to a wide choice of advanced telecommunication services.

Similar direction is found in statutory provisions regarding universal service. In Public Utilities Code § 871, the Legislature states that the "feasibility"

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[133] CAL. PUB. UTIL. CODE § 7099(c).

[134] CAL. PUB. UTIL. CODE § 882(c)(2).

[135] CAL. PUB. UTIL. CODE § 882.

of redefining universal telephone service to include advanced telecommunication services depends on the following considerations:

> (1) Technological and competitive neutrality.
>
> (2) Equitable distribution of the funding burden for redefined universal service . . . among all affected consumers and industries, thereby ensuring that regulated utilities' ratepayers do not bear a disproportionate share of funding responsibility.
>
> (3) Benefits that justify the costs.[136]

The Legislature reiterates its intent that our policies encourage development of a wide variety of advanced telecommunication facilities and services.

This desire is consistent with that expressed by Congress. Section 706 of Telecommunications Act of 1996 declares that it "shall be the policy of the United States to encourage the provision of new technologies and services to the public."[137]

C. Telecommunications Regulations Must Continue to Meet the Social Policies Embodied in Statutes

Even as we act to bring current regulations more in line with the policies supported by federal and state statutes and with the emerging realities of telecommunications markets, it is important to acknowledge that current telecommunications regulations also support major social policies. These social policies are grounded in state statutes, and are the basis for programs using large subsidies to achieve their purposes. Public Utilities Code § 709 declares that

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[136] CAL. PUB. UTIL. CODE § 871.7(d).

[137] § 706(a) of the Telecommunications Act of 1996, Pub. L. 104-104, 110 Stat. 56 (1996), reproduced in the notes under 47 U.S.C. § 157(a).

California shall "continue our universal service commitment by assuring the continued affordability and widespread availability of high-quality telecommunications services to all Californians."[138]

The major social programs embodied in telecommunications policies include the California LifeLine (LifeLine) program for low-income users of telecommunications services,[139] a program to provide phone and calling assistance to the deaf and disabled community[140] and two programs to subsidize the cost of basic service in high cost service areas.[141] The Commission recently opened an investigation into the major public policy programs and described these programs as follows:

> The California LifeLine Program was established in 1984 (D.84-11-028) to comply with the Moore Universal Telephone Service Act, Pub. Util. Code §§ 871 -884. It is a means to achieve the public policy goal of providing affordable basic residential telephone service to low-income households and disabled individuals. The program is currently funded by a 1.29% surcharge on the intrastate service of telephone service subscribers. There is no cap on the surcharge level. The LifeLine fiscal year 2005-06 budget is $277.4 million and the fiscal year 2006-07 budget is $290 million. . . .
>
> The Deaf and Disabled Telecommunications Program began through the efforts of an employee volunteer program at Pacific Bell sometime prior to 1978. This volunteer group repaired and

138 CAL. PUB. UTIL. CODE § 709(a).

139 CAL. PUB. UTIL. CODE §§ 871.5 et seq. California LifeLine was formerly known as Universal LifeLine Telephone Service.

140 CAL. PUB. UTIL. CODE § 2881 et seq.

141 CAL. PUB. UTIL. CODE § 739.3 et seq.

sometimes provided equipment to Pacific Bell's hearing impaired customers. In 1978, the Commission issued Resolution T-9865 authorizing Pacific Bell to revise its tariffs to allow a special rate of $14.00 per month for a display terminal to certified deaf customers. Subsequent Commission resolutions and Decision 90642 (1979) modified and expanded the program ultimately resulting in the first steps toward formally establishing a program to provide specialized, supplemental equipment to hearing-impaired customers at subsidized rates. . . .

In 1981, the Legislature enacted Pub. Util. Code § 2881, which currently governs the program. The program is comprised of two components: The California Telecommunications Access Project, which lends equipment to eligible customers; and the California Relay Service, which enables eligible customers to use relay service to access the telecommunications network. The current surcharge for the program is 0.27% and cannot exceed one half of one percent. The fiscal year 2005-06 budget is $66.8 million and the fiscal year 2006-07 budget is $69 million. . . .

The California High Cost Fund A was created by D.88-07-022 to comply with Pub. Util. Code § 739.3 and is a source of supplemental revenue to small local exchange carriers serving high-cost areas of the state. Without this revenue, the basic exchange access line rates charged by the carriers would potentially be so high as to threaten the goal of available, affordable service to all California citizens. The current surcharge for the A Fund is 0.21%. The fiscal year 2005-06 budget is $42.7 million and the fiscal year 2006-07 budget is $58.8 million.

The California High Cost Fund B was established by D.96-10-066 to comply with Pub. Util. Code § 739.3 and to provide subsidies in high cost areas served by large and mid-size incumbent local exchange carriers. Formerly, these carriers used internal subsidies between low-cost-to-serve areas and high-cost-to-serve areas and subsidies from non-basic services to fund the cost of meeting the state's universal service goals of available, affordable service throughout California. The current B Fund surcharge is 2.0% and the fiscal year

2005-06 budget is $447.1 million and the fiscal year 2006-07 budget is $434.6 million.[142]

As this overview makes clear, these social programs have a significant impact on the telecommunications field. Each program is extensive, both in cost and numbers of participants.

Prudent policy requires that we consider the effect of any new regulations on these important public policy programs. We also will need to determine whether the scope and scale of these programs requires accommodations in the development of a new regulatory framework.

In conclusion, our statutory review indicates that we should consider the impact of any regulatory reform on our state's ability to (i) rely upon competition in the telecommunications marketplace; (ii) encourage development of a wide variety of new technologies and services; and (iii) support our state's public policy programs. We will reference and rely upon this statutory guidance in this decision's ensuing analysis.

IV. Two Major Policy Alternatives Developed in the Record

Although the OIR aspired to create a "uniform" regulatory framework, parties agreed that it would not be possible at this time for the Commission to adopt a completely uniform framework that applied to all communications carriers. The Commission does not have equal authority over all communication service providers.[143] It has different levels of jurisdiction over different

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[142] R.06-05-028 at 4-6.

[143] Opening Comments of Pacific Bell Telephone Company at 11 (May 31, 2005) (hereinafter "Pacific Bell Opening Comments"); Comments of the Office of Ratepayer Advocates at 3-14 (May 31, 2005) (hereinafter "ORA Opening Comments"); Comments

Footnote continued on next page

providers. For example, the Commission has been preempted from regulation of wireless rates for wireless carriers by Congress,[144] and it lacks jurisdiction over communications services provided to Internet users via VoIP. Our jurisdiction also often overlaps with that of other regulatory authorities, such as the FCC.[145]

Recognizing that we cannot adopt a fully uniform regulatory framework, parties instead developed a record that fleshed out two general policy alternatives: one that would afford greater pricing flexibility to the ILECs, and another that would maintain the status quo. We describe specific parties' regulatory framework recommendations in greater detail below.

A. Increase Price Flexibility

Most parties suggest that the Commission adopt a revised framework that gives ILECs increased pricing flexibility. Parties recommending enhanced pricing flexibility include the following: AT&T, Verizon, DRA, Cox, Frontier, and SureWest. This section summarizes these various parties' proposals.

1. AT&T

AT&T supports the greatest degree of pricing flexibility. It asserts that existing price regulation distorts operating and investment decisions, because it

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of the United States Department of Defense and All Other Federal Executive Agencies at 5 (May 31, 2005) (hereinafter "DOD/FEA Opening Comments").

144 See Section 332(c)(3) of the Telecommunications Act of 1996, which prohibits states from regulating wireless rates and entry, but reserves to the states authority over the terms and conditions of wireless service; ORA Opening Comments at 4-6.

145 ORA Opening Comments at 6-9.

is applied asymmetrically.[146] AT&T adds that technological innovation and competition across voice platforms have eliminated any ability to meaningfully evaluate competitiveness on a service-by-service basis.[147] Thus the company calls upon the Commission to abandon the NRF framework adopted in 1989, and adopt a new framework that permits a significant amount of pricing freedoms.[148]

AT&T's proposed regulatory framework would eliminate a variety of existing price regulations. Imposing the company's proposed framework would eliminate earnings regulation (i.e., price index, earnings sharing mechanism, and imputation of Yellow Pages directory earnings).[149] AT&T also would permit full pricing flexibility for all residential and business services.[150] Specifically, the company's proposed framework would eliminate all pricing restrictions and limitations, including service categories, price floors (including imputation rules), price ceilings, the requirement to provide cost data, and any other limitations on pricing.[151] AT&T further submits that carriers should be free to

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146 Opening Brief of Pacific Bell Telephone Company at 54 (Mar. 6, 2006) (hereinafter "Pacific Bell Opening Brief"); Pacific Bell Opening Comments at 15-16; Opening Comments of Robert Harris at 50 (May 31, 2005) (testifying on behalf of AT&T).

147 Pacific Bell Opening Brief at 55.

148 Id. at 58.

149 Id. at 75.

150 Id.

151 Id.

offer geographically deaveraged prices too.[152] The company, however, would support placing a price cap on current basic residential rates until June 1, 2007.[153]

With respect to Commission review of its operations, AT&T recommends that the Commission adopt a one-day advice letter process for revising prices, terms, and conditions (without cost support) for all residential and business services.[154] AT&T further requests streamlined contract filing procedures (effective within 15 days) and recommends full pricing flexibility for contracts, by eliminating pricing restrictions and associated cost data requirements.[155]

2. Verizon

Verizon supports a significant amount of ILEC pricing freedoms too. It contends that our complex economic regulations, designed over a decade and a half ago for a wireline-only world, inhibit the efficient operation of the modern communications market.[156] According to Verizon, imposing rules only on ILECs depresses the full potential of the voice market and harms consumers.[157] Verizon maintains that competition as a whole suffers as long as any single competitor is constrained in its ability to respond quickly to consumer demand; offer new

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[152] Id. at 58.

[153] Id. at 75, n.305.

[154] Id. at 75.

[155] Id.; Opening Comments of Emery Borsodi at 25-26 (May 31, 2005) (testifying on behalf of AT&T).

[156] Opening Brief of Verizon California (March 6, 2006) (hereinafter "Verizon Opening Brief") at 1.

[157] Id.

services and new bundles; provide leading-edge technologies; respond to other competitors' moves; and realize the full risks and rewards of its actions.[158] A lack of competition, in turn, causes consumers to suffer too.[159]

Verizon's proposed regulatory framework urges full pricing flexibility for all "non-basic" retail services.[160] It recommends that a price increase be allowed to go into effect twenty-five days after a company files an advice letter and notifies customers of the price increase; it suggests that a price decrease be allowed to go into effect the day after an advice letter filing.[161]

Verizon also supports capping basic business and residential services for a three-year transitional period.[162] This proposed cap would ensure revenue neutrality across "basic services."[163] That is, price increases to "basic" services above the three-year cap would require Commission approval, but would be permitted in response to Commission-mandated price decreases to any other price-regulated service, e.g., switched access service.[164]

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158 Id.

159 Id.

160 Id. at 3.

161 Id. at 3; Comparison of URF Proposals Matrix (October 13, 2005) (hereinafter "Comparison of URF Proposals").

162 Verizon Opening Brief at 3.

163 Id.

164 Id.

Full downward pricing flexibility and downward geographic deaveraging would be permitted during the proposed three-year transitional period.[165] Price floors would be eliminated.[166] Price regulated (basic services) and non-price-regulated services, including affiliate services, could be offered on a bundled or promotional basis without restriction (e.g., time or geographic limitations) and would be accorded full pricing flexibility.[167]

Under Verizon's proposed framework, Individual Case Basis (ICB) contracts would be effective on their own terms and would be filed with the Commission within thirty days of execution.[168] No cost support would be required.[169] Any advice letter filings could be protested only for improper noticing or filing procedures.[170] Tariffs would continue to be filed.[171]

3. DRA

DRA submits a two-part proposal for a new regulatory framework. In the first part, DRA recommends the elimination of virtually all price regulation for

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165 Id.

166 Id.

167 Id.

168 Id.

169 Id.

170 Cost support would not be required.

171 Verizon Opening Brief at 4.

packaged service offerings.[172] DRA also proposes the elimination of downward pricing restrictions for all services,[173] and the elimination of upward price limits for most stand-alone services.[174] Thus, if carriers want to adjust prices up or down for most stand-alone services, they would be free to do so.

The second part of DRA's proposal would impose a price cap on primary residential lines, single-line business access service, Private Branch Exchange (PBX) trunks,[175] and associated services for recurring and non-recurring charges.[176] DRA urges the Commission to retain the capped prices for a minimum of three years, at the end of which the Commission would review the status of the relevant market(s) in California to determine if competition is sufficient to constrain prices for residential and small business basic service.[177] If the Commission determines that competition in the relevant market(s) has developed to the point that it poses sufficient price constraints, DRA recommends that the Commission then should eliminate the price cap.[178]

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172 Only a one-day filing for price changes and a protest period, as currently exists, would remain. Brief of the Division of Ratepayer Advocates at 5 (Mar 6, 2006) (hereinafter "DRA Opening Brief").

173 Id.

174 Stand-alone services that would not be affected by this proposal are primary residential and single-line business access lines; PBX trunks; and associated services for both recurring and nonrecurring costs (NRCs).

175 PBX trunks connect a customer's private switch to a telephone company's central office.

176 DRA Opening Brief at 5.

177 Id.

178 Id.

DRA maintains that basic rate increases, at least during the next three years, may have a number of adverse consequences. First, it states that these increases may encourage residential customers to forgo their primary wireline connection entirely, or to subscribe to less reliable services.[179] Second, DRA contends that basic rate increases may harm small businesses that depend on analog lines for their operations (e.g., to verify credit card transactions).[180] Third, it asserts that the increases could decrease coin-operated pay telephone (COPT) availability and public payphone services, which are important to people too poor to subscribe to their own phone service.[181]

4. Cox

Cox makes three primary recommendations in this phase of the URF proceeding. First, Cox states that the Commission should eliminate the high-cost fund subsidies the ILECs receive before allowing ILECs to have downward pricing flexibility for basic services.[182] Cox adds that these restrictions against downward pricing flexibility should apply equally to bundled services that contain the subsidized service.[183] Second, Cox asserts that the Commission should not permit geographic deaveraging of basic services[184] Finally, Cox

179 Id. at 17-18.

180 Id.

181 Id.

182 Opening Brief of Cox California Telecom at 17 (Mar 6, 2006) (hereinafter "Cox Opening Brief").

183 Id. at 16-17.

184 Id. at 16.

contends that the Commission should continue to impose some reasonable regulation on promotions, in terms of both duration and repetition.[185]

Cox contends that if its recommendations are not adopted, the ILECs will be able to abuse their market power.[186] According to Cox, ILECs might lower prices in target areas where they face the most competition, and thereby discourage new entrants and drive out their competitors in those markets.[187]

5. Frontier and SureWest

Frontier and SureWest argue that the hallmark of a new regulatory framework should be full upward and downward pricing flexibility for all non-basic ILEC services.[188] They also agree that the process for modifying the prices and terms of ILECs' service offerings should be streamlined.[189] The two mid-size ILECs reason that they should be given pricing flexibility like other competitors in the voice marketplace.[190]

Frontier and SureWest, however, support a two-year cap on "primary line residential services."[191] To the extent that price caps remain on the primary line

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185 Id.

186 Id.

187 Reply Brief of Cox California Telecom (Mar 24, 2006) at 10 (hereinafter "Cox Reply Brief")

188 Opening Brief of Citizens Telecommunications Company of California at 19 (March 6, 2006) (hereinafter "Citizens Opening Brief"); Opening Brief of SureWest Telephone at 22 (March 6, 2006) (hereinafter "SureWest Opening Brief").

189 Citizens Opening Brief at 25-26; SureWest Opening Brief at 29-30.

190 Citizens Opening Brief at 19-20; SureWest Opening Brief at 23.

191 Citizens Opening Brief at 22; SureWest Opening Brief at 25.

residential services, the two companies urge that an opportunity be provided for revenue-neutral rate rebalancing on these services.[192]

B. Maintain the Status Quo for Most Local Exchange Services

Only TURN argues that the Commission should largely maintain pricing regulation in its current form. This section reviews the basis for TURN's position and describes details of its recommendation.

TURN bases its recommendations upon its assessment of ILECs' market power. TURN states that its analyses demonstrate a high degree of market concentration in the four ILECs' service territories, with market conditions varying greatly within the large ILECs' territories.[193] TURN adds that intermodal alternatives currently are not substitutes for ILEC local exchange service.[194]

Given its assessment, TURN argues that prices for most ILEC services should be frozen for three years and then reviewed by the Commission at the end of that time.[195] Specifically, it states that prices should remain frozen for residential and business primary lines; local usage; Zone Use Measurement (ZUM); Extended Area Service (EAS); recurring and nonrecurring charges (NRCs); and additional lines for business and PBX trunks.[196] TURN would not

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[192] Citizens Opening Brief at 23; SureWest Opening Brief at 26.

[193] Opening Brief of The Utility Reform Network at 7-10 (March 6, 2006) (hereinafter "TURN Opening Brief").

[194] Id. at 7-20.

[195] Id. at 34.

[196] Id. at 34-35.

afford ILECs pricing flexibility based on revenue neutrality grounds.[197] After three years have passed, TURN states that the Commission should allow pricing flexibility only if subsequent Commission monitoring and review show this change is warranted.[198] TURN adds that all ILEC services should be required to be priced higher than the lesser of long-run incremental costs or the tariffed price on the date an ILEC market is deregulated.[199]

Regarding Commission review of ILEC operations, TURN declares that while there is no need to have cost support for advice letters/contracts, the Commission staff should nevertheless retain authority to ask for necessary information.[200] TURN urges the Commission to apply the following uniform advice letter process to all competitors: one day for price decreases; thirty days for price increases, with twenty-five days for customer notice.[201] TURN adds that the same advice letter process for price increases should be applied to grandfathering and/or withdrawing of services.[202] While it supports eliminating earning regulation, TURN states that ILECs should continue to report intrastate earnings too.[203] TURN contends Yellow Page revenue should be included in

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[197] Id. at 36.

[198] Id.

[199] Id. at 36-37.

[200] Id. at 38.

[201] Id.

[202] Id. at 39.

[203] Id. at 40.

these reports.[204] Finally, TURN recommends the following uniform rule for all competitors' contracts: Contracts should become effective on their own terms, with fifteen-day filing requirements.[205]

In conclusion, parties to this proceeding recommended a variety of pricing frameworks, ranging from AT&T's proposal to TURN's proposal. We evaluate these proposals, and the evidence for them, in the sections following below.

V. Level of Competition in Telecommunications Markets

Since proposed policy reforms would limit or eliminate regulations developed to check the power of monopoly carriers, we must address whether we can rely on market forces, rather than command and control rules, to ensure that rates are "just and reasonable."[206] The central factual issues in this proceeding concern whether new policies, technologies, and developments in telecommunications markets over the last eighteen years have limited the ability of incumbent carriers to exercise market power. Market power is the ability of a company to sustain prices at levels above those a market would produce by restraining the supply of telecommunications services to the market.

In this proceeding, we examine the following items when making our assessment of the ILECs' market power:

1) the services, customers, and geographic extent of the relevant communications market for our analysis;

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[204] Id. at 41.

[205] Id. at 38.

[206] CAL. PUB. UTIL. CODE §451.

2) the extent to which either entry or the threat of entry by firms to "contest" a market is sufficiently real to prevent the exercise of market power by the incumbents;

3) the extent to which competing communications technologies can supply communications services and thereby check the market power of the wireline incumbents;

4) the extent to which the presence of competitors in the service territories of ILECs already offers an alternative supply of telecommunications services and thereby provides a check on market power.

Factual findings on these issues will help guide us in our determination of whether and to what extent it is reasonable to change ILEC pricing rules and accompanying reporting, monitoring, and auditing regulations.

A. The Relevant Market for Competitive Analysis: Substitutability and Presence of Competitors

This section assesses what is the relevant market and what is its geographic extent. In particular, it looks at whether the communications services provided by cross-platform technologies are real substitutes for circuit-switched wireline services.

1. Positions of Parties

This section reviews the positions of the parties on the relevant market for our competitive analysis. Parties commenting on the proper scope of the market reviewed include the following: Verizon, AT&T, SureWest, Frontier, DRA, TURN, DOD/FEA, DisabRA, CPA, CCTA, Greenlining, and XO Communications (XO).

a) Verizon

Verizon argues that the market for telecommunications services is the broad market for voice communications services, but any assessment of the level of competition should take place at the end-office level. The ILEC declares that under standard economic analysis, it is appropriate to consider four factors in analyzing competition:

- Which services compete with each other?
- Are those services available in the marketplace?
- Are there significant barriers to entry and expansion in the marketplace?
- What are the regulatory constraints and regulatory factors that have affected the pattern of competition that is observed in the marketplace?[207]

These factors guide Verizon's review of competition in the telecommunications marketplace.

Verizon contends that a competitive analysis should look not only at voice services that are perfect substitutes, but also at services that qualify as "reasonably good substitutes." [208] It explains that "[s]ubstitutable products serve to constrain one another's prices, because if one product were to experience a price increase, consumers would purchase other products that are reasonable substitutes."[209] According to Verizon, evidence that a service qualifies as a reasonably good substitute includes whether "the services appear to serve the

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[207] Declaration of Dr. Debra J. Aron at ¶ 35 (May 31, 2006) (testifying on behalf of Verizon) (hereinafter "Aron Opening Comments").

[208] Id. at ¶ 39.

[209] Id.

same or similar function from the customers' standpoint; customers view them as reasonably equivalent; and/or they are objectively similar from a technical standpoint. Other relevant evidence includes whether the services are sold in the same marketing channels, or whether competitors market their services as a substitute for one another."[210]

Applying these principles, Verizon concludes "that a variety of intermodal and intramodal offerings are relevant substitutes for Verizon's services and apply competitive pressure on them. These include services offered by CLECs, cable telephony, wireless, and some VoIP providers."[211]

Verizon cites multiple sources as evidence that wireless and wireline services are reasonable substitutes for each other and compete in the same marketplace. It cites statistics that demonstrate a negative correlation between the number of wireline customers and the number of wireless customers:

> According to the FCC, the number of landlines in California has *decreased* by 1.57 million from end-of-year 2001 to June 2004, while during the same period, the number of wireless subscribers in California *increased* by 6.52 million. . . . While this inverse relationship between wireline and wireless customer growth in California does not, by itself, demonstrate direct substitution of wireless for wireline lines, it is consistent with findings of analysts and surveys that show significant wireless substitution for wireline access.[212]

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[210] Id. at ¶ 45.

[211] Id. at ¶ 51

[212] Id. at ¶ 62.

Verizon also relies upon a series of customer surveys demonstrating a "significant growth in wireless-only households."[213] For example, Verizon cites a Deutsch Bank study that finds: "that wireless growth accounted for about *47 percent of ILEC primary line residential landline losses* (as measured relative to where ILEC residential primary lines would have been, after accounting for economic growth)."[214] Verizon adds that California ILECs, including Verizon, have begun losing landline phone lines at a rate unprecedented since NRF was adopted.[215]

Verizon also considers VoIP services as competitors with its traditional telecommunications services. According to Verizon, some industry observers believe that VoIP is "an even bigger threat to the incumbent carriers going forward."[216] The ILEC, in particular, deems cable companies "[a]mong the most important players in the VoIP arena."[217] Citing a study by Deutsch Bank, Verizon concludes that "projections of cable telephony represent a growth rate of about 100 percent per year between 2004 and 2008, and nearly 25 million subscribers by 2013."[218] Verizon adds that Cox has "more than 1.2 million

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[213] Id. at ¶ 63.

[214] Id. at ¶ 64.

[215] Id. at ¶ 67.

[216] Id. at ¶ 73.

[217] Id. at ¶ 76.

[218] Id. at ¶ 78.

residential telephony customers across 17 telephone markets, and that its telephone service is available to 6.5 million homes in those markets."[219]

Verizon argues that these market developments show that VoIP is a substitute for basic switched local telecommunications service. "In addition to providing a substitute for traditional phone service and features," Verizon observes that "standard VoIP offerings typically include a much richer and more flexible slate of features than does the traditional telephone network." [220] Examples of these features include the following: music or messaging on hold and unified messaging; multiple telephone lines (i.e., telephone numbers) on a single connection; and multiple area code assignments (which means that the user can implement his or her own foreign exchange service)."[221]

Verizon provides a market analysis for each wire center to determine the scope of this competition.[222] Thus, although the ILEC claims to see a rather broad market including all voice communications services as competitors with traditional phone services, its actions suggest that it finds that appropriate competitive analysis requires the examination of specific geographic markets to determine whether other competitors are present.

b) AT&T

AT&T urges the Commission to recognize that the relevant market is the broad market for communications services, and any consideration of competition

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[219] Id. at ¶ 80.

[220] Id. at ¶ 96.

[221] Id.

[222] See Id. at ¶ 105 and Table 6 (proprietary).

in that market should include "all types of competitors, regardless of technological differences, in that market now and in the foreseeable future. . . ."[223] California's largest ILEC reasons that consumers use combinations of mobile wireless, fixed wireless, cable services, Internet messaging, and voice services as alternatives to traditional wireline telephones.[224] According to AT&T, there has been a "shift in technologies and consumer preferences"[225] resulting from "the rapid emergence and growth of technological alternatives to wireline communications."[226]

Specifically, AT&T declares that there are ample substitutes for local service. AT&T characterizes Basic Local Exchange Service (BLES) as "the product of a regulatory definition created decades ago." [227] It then dismisses the significance of this definition: "In competitive markets, product configurations are not determined by regulatory definitions, but respond and evolve in response to customer demands."[228]

Concerning the issue of substitutes, AT&T argues that the "critical factor in determining whether services are competitive substitutes is whether they have the actual or potential ability to take significant amounts of business away from

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[223] Pacific Bell Opening Brief at 10.

[224] Id. at 11 (citing Harris Opening Comments at 11).

[225] Id.

[226] Id. at 10.

[227] Id. at 12 (citing Taylor Reply Comments at 5 and Harris Reply Comments at 6, 10).

[228] Id. (citing Taylor Reply Comments at 5 and Harris Reply Comments at 6,10).

each other."[229] Dr. Robert Harris, testifying on behalf of AT&T, argued that competitors to wireline service include mobile wireless, cable, or VoIP:

> [I]t is not necessary that cable, mobile wireless, fixed wireless, and VoIP providers compete directly in each and every market segment. Rather, the force of intermodal competition arises from the different economic attributes of the competing modes, one of which may have competitive advantages in some market segments, while another mode has a competitive advantage in some other market segments. The greatest benefits of intermodal competition come from dynamic changes, as modes strive to gain a competitive advantage or reduce a competitive disadvantage relative to other modes.[230]

AT&T concludes that "[e]ven if only a small percentage of customers actually shift their usage based on price changes, the fact that this shift occurs causes carriers to take this into account when setting prices, thereby constraining prices."[231]

AT&T adds that an analysis of competition that "include[s] evaluation of competitive alternatives for individual services and for discrete geographic subdivisions of the state" would produce "erroneous results."[232] It reasons that the individual service approach "fails to properly consider intermodal services that function as substitutes," and "the majority of communications services are sold in bundles and not on a stand-alone basis."[233] Concerning the extent of

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229 Id. at 12 (citing Harris Reply Comments at 14-15).

230 Harris Reply Comments at 24.

231 Pacific Bell Opening Brief at 14 (citing Harris Opening Comments at 12-13; Taylor Opening Comments at 5, 23-24).

232 Id. at 19.

233 Id.

geographic analysis for our assessment, AT&T maintains that "it is not necessary to examine the market conditions individually in each separate geographic market because the conditions that give rise to contestability are the same in each: the successful implementation of the market-opening requirements of the Telecommunications Act."[234]

Finally, AT&T encourages the Commission to be "forward-looking":

> Not only is it reasonably clear that established forms of intramodal and intermodal competition will grow, emerging forms of intermodal competition will blossom. For example, WiMax, a fixed wireless technology that extends the reach of high-speed stationary wireless service by miles, is being deployed now. Similarly, broadband service over power lines ("BPL") has been commercially deployed in some communities and is under trial in dozens of locations.[235]

AT&T argues that forward-looking regulation is prudent because "[w]hen changes are occurring rapidly and at an accelerating rate, as they are in the communications market, policies must be set on a forward-looking basis, not on historical data or a snapshot view of the market at the time of the proceeding, which could hinder on-going competition."[236]

c) SureWest and Frontier

SureWest and Frontier apply the standard of "reasonable interchangeability of use" to define the relevant markets that affect competition

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[234] Taylor Opening Comments at 11.

[235] Pacific Bell Opening Brief at 15 (citing Harris Opening Comments 34).

[236] Id.

for wireline services.[237] They maintain that "as long as some significant percentage of customers views a competing service as a substitute for traditional wireline service, this is sufficient to make the services substitutes from an economic standpoint."[238] Accordingly, SureWest and Frontier assert that the relevant market includes CLEC, wireless, and VoIP services.[239]

Both SureWest and Frontier assert that they face significant intramodal and intermodal competition within this market. They note that while population is growing in their service territories, residential access line use is dropping.[240] While "it is difficult to determine exactly which services customers are selecting in place of [SureWest's and Frontier's] wireline service," whether "wireless, . . VoIP, . . CLECs, or . . . another type of competitor, the customers are going somewhere and in significant numbers."[241]

Given "the presence of robust competition in nearby areas of the Sacramento metro areas" served by SBC,[242] the mid-sized ILECs suggest that they

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237 Id.

238 SureWest Opening Brief at 5 (citing Harris Opening Comments at 10-12); Citizens Opening Brief at 4 (citing Harris Opening Comments at 10-12).

239 SureWest Opening Brief at 6 (citing Aron Opening Comments at 32); Citizens Opening Brief at 5 (citing Aron Opening Comments at 32).

240 SureWest Opening Brief at 15 (citing SureWest Opening Comments at 9); Citizens Opening Brief at 11-12 (citing Citizens Reply Comments at 9).

241 SureWest Opening Brief at 16; Citizens Opening Brief at 12-13.

242 SureWest Opening Brief at 14; Citizens Opening Brief at 10-11.

should be afforded the same remedies applying to SBC.[243] In support of this position, they cite FCC and U.S. Appeals Court rulings in which "the existence of competition in one market is relevant to determining whether competition is impaired in a similar geographic market."[244] SureWest and Frontier add that they should receive further consideration, because of "the size disparities between [them] and Comcast and SBC," their competitors. They observe that the FCC took comparative size into consideration in a recent decision that provided regulatory relief to a smaller ILEC service provider.[245]

SureWest also specifically addresses its own service area, "a largely suburban area in and around the cities of Roseville and Citrus Heights in the Sacramento Metropolitan area." The mid-sized ILEC states that "the physical and situational similarities between SureWest's service territory and the service territories served by the large ILECs" mean that competitive data offered AT&T's and Verizon's experts can readily be applied in the same manner to SureWest's circumstances.[246] Alleged similarities between the larger ILECs and SureWest include serving "a largely suburban area" with "demographics and geographical

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[243] SureWest Opening Brief at 13-14 (citing FCC Triennial Review Remand Order at 43,45 and U.S. Telecom Association v. FCC, 359 F. 3d. 554 (D.C. Cir 2004)); Citizens Opening Brief at 10-11 (citing FCC Triennial Review Remand Order at 43,45 and U.S. Telecom Association v. FCC, 359 F. 3d. 554 (D.C. Cir 2004)).

[244] SureWest Opening Brief at 13-14 (citing FCC Triennial Review Remand Order at 43,45 and U.S. Telecom Association v. FCC, 359 F. 3d. 554 (D.C. Cir 2004)); Citizens Opening Brief at 10-11 (citing FCC Triennial Review Remand Order at 43,45 and U.S. Telecom Association v. FCC, 359 F. 3d. 554 (D.C. Cir 2004)).

[245] SureWest Opening Brief at 14-15 (citing FCC WC Docket No. 04-223 at ¶23); Citizens Opening Brief at 11 (citing FCC WC Docket No. 04-223 at ¶23).

[246] SureWest Opening Brief at 11.

characteristics that are no different than any of the surrounding SBC areas" and "no break in development between SBC's and SureWest's service territory."[247]

Frontier likewise emphasizes how it is similar to SBC and Verizon. Like the larger ILECs, Frontier points out that it "serves a number of different geographical areas," "the bulk of [its] access lines are in a non-rural area, the Elk Grove exchange" that "has demographics and geographical characteristics that are no different than any of the surrounding SBC areas."[248] Frontier adds that it faces competition from "numerous wireless carriers, . . . a variety of stand-alone VoIP providers," "a number of CLECs," and "will soon face vigorous competition in the voice market from incumbent cable companies." In light of this competition, Frontier believes that "the competitive data offered by Dr. Aron and Dr. Harris can be readily applied to Frontier's circumstances in the same manner that these data can be applied to the larger ILECs."[249]

d) DRA

DRA focuses its discussion on what it calls "essential" services. DRA argues that "[t]he more 'essential' the service, the greater DRA's concern about the effect of unwarranted price increases" for the sake of "universal service and public safety."[250] Accordingly, DRA urges us to require a "high standard of proof that the existing degree of competition – not predicted, forecasted competition next year or the year after – will suffice to protect captive customers

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[247] Id. at 10.

[248] Citizens Opening Brief at 8.

[249] Id. at 8-9.

[250] DRA Opening Brief at 17-18.

from unreasonable price hikes. Such proof should consist of hard evidence concerning the current level and direction of competition . . . from alternative services that are demonstrably comparable in 'cost, quality and maturity' to . . . wireline basic exchange services."[251]

DRA maintains that it, along with other parties, has "presented substantial evidence showing that there is limited competition today for residential and single-line business basic exchange services."[252] It argues that "competition for primary-line residential services and single-line business services is limited and, at best, is growing slowly or actually has declined over the past few months."[253] DRA specifically highlights two ways in which it believes intermodal competition currently is lacking:

> [I]ntermodal competitors may find it difficult or impossible to offer service throughout the ILECs' service territories (e.g., because of franchise limits for cable providers). Second . . . intermodal competitors offer services that consumers may not always view as being comparable to the wireline services they are taking.[254]

DRA criticizes the ILECs' evidence for being "very general[,] . . typically based on nationwide data," and "fail[ing] to address specific services."[255] It adds that the ILECs' "heavy" reliance on "projections of increased

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[251] Id. at 18 (citing Triennial Review Order, 18 FCC Rcd at 17295, ¶97 and 499 n. 1549).

[252] Id. (citing DRA Reply Comments at 24-92; Exhibits 1-9; Roycroft Opening Comments; Roycroft Reply Comments).

[253] Id. at 20.

[254] Id. at 22.

[255] Id. at 27 (citing 2 Tr. at 239-240; 3 Tr. at 478, 509).

competition" is inappropriate.[256] DRA asserts that "[t]his evidence is simply too tenuous to justify eliminating price caps for these essential services either today or at some date certain two or three years hence."[257]

DRA's review of the "different mix of cable and wireless providers across the four ILECs' service territories" convinces it "that, at a minimum, each of these service territories should be treated as a separate geographic market." [258] Thus, it contends that the Commission should not justify any greater pricing flexibility for SureWest and Frontier based on the competitive analyses performed by AT&T and Verizon.[259] DRA also counsels the Commission to avoid relying on data AT&T and Verizon presented on competition in other jurisdictions, because "at least with respect to facilities-based cable and wireless alternatives, . . . the competitive offerings in other states may differ significantly from those available today (or likely to be available in the near future) in California."[260]

e) TURN

TURN asserts that "the ILECs thoroughly dominate the local exchange market."[261] It states that intermodal alternatives, such as wireless and VoIP, do not qualify as "competitive substitutes for wireline local exchange service."[262]

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[256] Id. at 19.

[257] Id. at 19-20.

[258] Id. at 22-23.

[259] Id.

[260] Id. at 22-23.

[261] TURN Opening Brief at 4.

Testifying on behalf of TURN, Dr. Trevor Roycroft contended that "evaluation of the potential for consumers to substitute requires a determination of the economic characteristics of products or services."[263] Roycroft then proceeded to list characteristics he deemed relevant to substitutability. He noted that the characteristics of "basic local exchange service" (BLES) include "affordable monthly prices," "unlimited local calling," E911 availability, number portability, fax/ISP access, and independence from the power grid.[264] Another important feature, according to Roycroft, is "availability on a stand-alone basis," in that "the consumer is not required to purchase or utilize a broadband connection when purchasing BLES, nor are they required to purchase video programming." He added that "the customer is not required to enter into a long-term contract when purchasing BLES, [and] there are no penalties for early termination, month-to-month service is available."[265] Roycroft also provided a table to illustrate the "lack of comparability associated with many aspects of CLEC and intermodal alternatives."[266]

Roycroft further urged the Commission to consider the "regulatory treatment of vertical features," i.e., services that are added on top of BLES.[267] He explained that features such as 976/900 blocking, control over white-page

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262 Id.

263 Roycroft Opening Comments at ¶38.

264 Id.

265 Id.

266 Id. at ¶39 (referring to Table 2).

267 Id. at ¶ 40.

listings, caller ID blocking, and call trace "can play an important privacy protection or public safety role" and "deserve special consideration in any regulation plan."[268] In general, however, Roycroft conceded that most features, "by playing a complementary role with BLES, do not provide the same critical public interest role as BLES itself" and so merit greater pricing flexibility.[269]

f) DOD/FEA

Concerning telecommunications markets, DOD/FEA follows the FCC's regulatory categories and discusses both the "mass" and "enterprise" markets as they apply in the California setting. While it believes that the ILECs "face increased service competition,"[270] DOD/FEA considers cable the "principal" and "only effective competitor to the ILECs in the mass market for the foreseeable future."[271] DOD/FEA anticipates that "both the ILECs and the cable companies [will] compete . . . using both circuit switched and Voice over Internet Protocol . . . technologies."[272] The market, under this projection, will be that of a duopoly. DOD/FEA cautions, "[w]hile duopolies provide a choice to consumers, they do not create an effective restraint on prices."[273]

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268 Id. at ¶ 41.

269 Id. at ¶ 40.

270 DOD/FEA Opening Brief at 4 (citing Pacific Bell Opening Comments at 108; Verizon Opening Comments at 4; SureWest Opening Comments at 2; Citizens Opening Comments at 4).

271 Id. at 6.

272 Id.

273 Id. at 7.

Nevertheless, DOD/FEA considers the enterprise market "to be reasonably competitive in most areas now."[274] DOD/FEA suggests that "[t]he multi-billion dollar SBC/AT&T and Verizon/MCI mergers in fact appear to be largely driven by the desire to capture enterprise market customers."[275]

DOD/FEA adds that it thinks that Broadband over Power Lines (BPL) technology "does appear to have the potential for providing a third transmission path."[276] But DOD/FEA states the caveat that "it will be some years" before BPL is a viable third party competitor.[277]

g) DisabRA

DisabRA "believes that the record supports DRA and TURN's arguments that the ILECs continue to enjoy significant market control."[278] It is primarily concerned, however, with the market for persons with disabilities and limits its discussion accordingly.

DisabRA asserts that "the largest wireline providers face very little competition in their provision of services to Californians with disabilities."[279] According to DisabRA, service providers, as a result, are "unwilling to offer

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274 Id.

275 Id.

276 Id.

277 Id. (citing DOD/FEA Opening Comments at 4; Broadband Deployment in California, California Public Utilities Commission at 30-32 (May 5, 2005)).

278 DisabRA Opening Brief at 3.

279 Id. at 11-12.

accessible or disability-related services and products to Californians with disabilities because they perceive the disability market as unattractive."[280]

DisabRA argues that basic wireline service is highly desirable to disabled users and other services cannot substitute for it. Testifying on behalf of DisabRA, Dmitri Belser states that individuals with disabilities "tend to be very reliant on the network."[281] He explains that unlike "many of the newer technologies, basic wireline service is generally physically accessible, particularly with adaptive equipment." [282] Belser adds that basic wireline service, as compared to other alternatives, is "more affordable and reliable."[283] ILECs, according to Belser, are also preferred by many disabled customers because they provide large print bills[284] and superior customer service.[285]

h) CPA

California Payphone Association (CPA) is principally concerned with the market for pay telephones. CPA argues that a pay telephone "serves essential communications needs."[286] It notes that some pay telephones are "'many

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280 Id.

281 Id. at Attachment 2, 2.

282 Id. at Attachment 2, 4.

283 Id. at Attachment 2, 5.

284 Id. at Attachment 2, 2.

285 Id.

286 CPA Opening Brief at 7.

customers' lifeline to the world,' serving as the means for making 911 calls and for communicating in cases of power outages and other emergencies."[287]

CPA declares that competition in this payphone market is "limited."[288] It explains that pay telephones are most likely to be of continuing importance in rural communities or low-income and minority neighborhoods,[289] and these "typical pay telephone locations are not likely to be sought after or served by the ILECs' facilities-based competitors."[290]

i) CCTA

CCTA does not focus in detail on the scope of market competition, but observes that "in many ways, incumbents already fully compete for customers. . . ."[291] It points out that ILECs offer "bundles of services that include phone, wireless phone, Internet and video services, and they have full pricing flexibility for their VoIP products, their wireless products, their Internet and video services, and their competitive phone-related services like long distance, voice mail, PBX trunks, centrex and a host of business and data services."[292]

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287 Id. (citing Murray Testimony, 5 Tr. at 857).

288 Id. at 1.

289 Id. at 4-5.

290 Id. at 7.

291 CCTA Opening Brief at 2 (citing 4 Tr. at 578).

292 CCTA Opening Brief at 2 (citing 4 Tr. at 578).

j) Greenlining

Greenlining is primarily concerned with issues relating to low-income, small business, and limited English markets. It asserts that "lack of information on [these] markets coupled with these groups' traditional vulnerability in the telecommunications market, [makes it] safe to conclude that these three groups are disadvantaged and should be provided the appropriate protections."[293]

In particular, Greenlining maintains that "it is clear that the needs of low-income, small business, and limited Spanish speakers were not specifically documented, analyzed, or commented on by any of the experts and embarrassingly ignored."[294] It notes AT&T and Verizon witnesses did not perform a competition analysis in these markets.[295] Greenlining adds that "[i]t is difficult if not impossible to do a proper analysis of competition" due to the complexity of ownership structure in the market, in which "'one substitute that challenges the traditional phone carriers is actually owned by the traditional phone carriers.'"[296]

k) XO

XO focuses on the high speed services. It asserts that "[a]lternative providers do not even approach having the ability to provide high speed

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[293] Greenlining Opening Brief at 9-10.

[294] Id. at 5.

[295] Id. at 3 (citing Harris Testimony, 2 Tr. at 296-303); Id. (citing Taylor Testimony, 3 Tr. at 509-512).

[296] Id. at 6 (citing En Banc Tr. at 59).

telecommunications services throughout any local exchange market in California":

> Intermodal forms of competition also do not provide any effective restraint on the ILECs' pricing, at least of services at speeds of DSl and above. Cable television companies do not offer such services and generally limit the services that they provide to residential, rather than business, customers located in their cable franchise service area. Wireless high speed services similarly are not available at the speeds and quality of landline services, particularly the services used by medium and large business customers.[297]

In contrast, XO observes that "the ILECs can offer such services virtually to each and every requesting customer in their entire local exchange territory."[298]

2. Discussion: Voice Services Constitute a Single Product, but Market Analysis Must Address Geography

Verizon's logical analysis provides the Commission with a sensible guide for examining the California telecommunications marketplace. Applying this systematic analysis, it is clear that the telecommunications market encompasses telecommunications broadly. Market participants include CLECs, cable companies, VoIP, and wireless service providers.

The evidence provided by Verizon on the changing pattern of telecommunications use in California – such as the decrease in landline phone access lines (1.57 million lines) coupled with the fourfold higher increase in

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[297] Opening Comments of XO Communications Services at 7 (May 31, 2005).

[298] Id.

mobile phone lines (6.52 million) as publicly reported by the FCC – suggests that landline and mobile services are *substitutes,* and not mere complements. If two services are complements, one would see their use rise and fall together. Instead, we see the use of wireless services rising rapidly while the use of wireline service falls. Survey data provided by Verizon, particularly those surveys of customers who have "cut the cord,"[299] also indicate that many customers consider mobile and landline telephony to be close substitutes in a competitive market.

Similarly, VoIP service qualifies as another substitute voice service that may offer service with more features and functionalities at a given price point than traditional circuit switched voice communications services. In particular, VoIP provided by cable telephone companies is a near-perfect substitute for circuit-switched wireline service.

We find that the historic practice of defining each telecommunications service as constituting a separate "market" is no longer relevant in today's technologically diverse telecommunications environment. Concepts like "Basic Local Exchange Service," "long distance service," "call waiting service," "call forwarding service," and "pay phone service," make little sense in an era dominated by telecommunications sold through bundled services.[300] Wireless telephone service, for example, treats all national calls the same; includes call-

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[299] By "cutting the cord," we refer to users who give up their landline phone service entirely and instead rely only on another telecommunications voice service ,such as a wireless, VoIP, or other technology.

[300] "Bundling" refers to the so called "triple play" sale of voice, data, and video in one package for a single price by major communications market participants, including telephone companies, cable providers, satellite service providers, wireless companies, BPL providers, and others.

waiting and voice-mail as part of the basic package; and provides communications services along all major highways that were once the sole province of pay telephone providers. The market analysis presented by AT&T's witnesses further convinces us that there is real and active competition from new, competing technological platforms.

In contrast, TURN urges the Commission to create separate markets for telecommunications services by seeking to find an attribute of a service that disqualifies it from being a "substitute" for another service. For example, it argues that VoIP cannot be deemed a substitute for local service, because the user needs a broadband connection in order to access VoIP service. We find that this analysis is flawed. It ignores that broadband connections are becoming increasingly available, and more and more Californians possess these connections.[301] Thus for a large portion of the market, VoIP is indeed a competitive service. Our market definition should take into account such technological developments in the dynamic telecommunications marketplace.

Additionally a service need not be identical to provide a competitive substitute. For example, we see that ballpoint pens, fountain pens, roller pens, and pencils all serve as writing instruments in the marketplace today. While no one pen or pencil is a perfect substitute for another, they often compete in serving a customer's need for a writing instrument. Similarly, a landline telephone, a wireless telephone, and a VoIP telephone all may compete to serve a consumer's need for voice communications.

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[301] See, for example, Ex. 40, Aron Opening Declaration at ¶ 26 citing "High-Speed Services for Internet Access: Status as of June 30, 2004," FCC Industry Analysis and Technology Division – Wireline Competition Bureau, December 2004, Table 8.

We also find no compelling reason to segment the market further by user characteristics, such as income or use characteristics (e.g., business or residential use, or level of use). In particular, there is no persuasive evidence that the patterns of use by low-income customers differ from other customers, or that competition in telecommunications markets will not benefit low-income customers. Likewise, concerning the type and level of use, this decision focuses on the retail services used at the lowest level of services. If we find that markets are open and competitive at these levels, then the same result follows for greater levels of use. We need not parse apart our market analysis to account for individual users' behavior.[302]

We recognize, however, that it is important to examine geographic markets. A substitute provides competitive discipline in a market segment only to the extent that it is available, and there is little dispute among the parties on this point. Even AT&T, which argues that the Telecommunications Act of 1996 makes a geographic granular analysis unnecessary, effectively acknowledges that geographic markets must be considered. AT&T bases its market-definition argument on the ubiquity of the FCC's scheme for opening telecommunications markets. The FCC scheme would not be effective if it did not operate in each geographic area.

R.06-05-028 will address further issues related to use by low-income and disabled customers. We acknowledge that landline telephones and services for

[302] We note that we take the special needs of low-income and disabled Californians to heart and that we have opened at special rulemaking, R.06-05-028 to address the issues associated with these communities. We refuse, however, to marginalize these communities by considering them so different from other consumers so as to constitute a completely separate market.

disabled individuals are tightly coupled: Telecommunications services used by the disabled community are tied to landline phone service, because public policy programs were conceived during the telephone monopoly era. But since reforms to such programs will be addressed directly in R.06-05-028, we hold that R.06-05-028 is the appropriate venue for considering the needs of that the disabled community. Moreover, as competition expands consumer choice, all consumers, including both the low-income and the disabled, benefit if public needs are examined directly and protected from withdrawal of services.

B. Analysis of Market Power

This section assesses whether the California market for telecommunications services is sufficiently competitive to enable California to replace current ILEC price regulations with a reliance on competitive market forces. In analyzing the level of competition in ILEC markets, this decision will describe the position of the different parties concerning the competition to ILECs provided by CLECs, wireless carriers, VoIP providers, and cable companies. We then describe the overall assessments of market power provided by parties. We note that in some cases a party's market power assessment follows from its analysis of cross-platform competition, while in other cases the market power assessment is based on an overall assessment of market conditions. The discussion section concludes by addressing the general question of whether ILECs continue to have market power in the telecommunications market.

1. Position of Parties on Competition from CLECs

This section discusses competition to ILECs provided by CLECs. Parties commenting on this topic include the following: Verizon, AT&T, SureWest, Frontier, DRA, TURN, DOD/FEA, DisabRA, and XO.

Before we describe these parties' positions, however, we hold that it is important that we review the regulatory backdrop to the comments. A brief review of prior state and federal regulatory developments is useful for both understanding and weighing various parties' arguments.

This review of regulatory developments necessarily begins with the enactment of the Telecommunications Act of 1996.[303] This Act, as we noted previously, sought to open local telecommunications markets to competition, and it expanded the ability of competitors to access ILECs' networks when providing local service. According to the FCC, the Act intended to increase competition through encouraging three types of entry: resale; investment in and ownership of full facilities; and leasing of unbundled network elements (UNEs).[304] The FCC describes these various types of entry as follows:

> [1] Total service resale requires the least initial capital investment, but is limited to reselling the incumbent LEC products with little opportunity to vary the products other than through improved customer service and bundling additional products with resold local service.
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> [2] Full ownership of facilities, on the other hand, allows the competitive LEC to totally engineer its own network, giving

303 Telecommunications Act of 1996, 47 USCS §§ 151.

304 *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket Nos. 01-338, 96-98, 98-147*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, 17145, ¶ 36 (2003) (Triennial Review Order, or TRO), corrected by Errata, 18 FCC Rcd 19020 (2003) (Triennial Review Order Errata), vacated and remanded in part, affirmed in part, *United States Telecom Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) (USTA II) cert. denied, 125 S.Ct. 313, 316, 345 (2004).

maximum control and flexibility but requiring the most capital investment.

[3] Leasing some parts of the network as UNEs, such as unbundled loops, can be accomplished at a lower initial capital investment than full facilities ownership and provides greater flexibility to develop services than does resale, but it may result in less network flexibility to add new services than does full facilities ownership.[305]

Leasing of UNEs, third in the list above, soon became a particularly popular form of competitive entry.

The specific statutory origin of leasing of UNEs is Section 251(c)(3). This section of the Telecommunications Act of 1996 adopted market-opening provisions that require incumbent LECs to make "elements of their networks available on an unbundled basis to new entrants at cost-based rates. . . ."[306] The cost-based price for a UNE was designated as the "Total Element Long-Run Incremental Cost" (TELRIC).[307] Under this scheme, access at cost to these

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[305] TRO ¶. 36 (footnotes omitted).

[306] *In the Matter of Unbundled Access to Network Elements; Review of Section 251 Unbundling Obligation of Incumbent Local Exchange Carriers, WC Docket No. 04-313, CC Docket No. 01-338*, Order on Remand, 20 F.C.C. Rcd. 2533, FCC 04-290 (rel. Feb. 4, 2005) (TRRO).

[307] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket Nos. 96-98, 95-185*, First Report and Order, 11 FCC Rcd 15499, at 15812-72, paras. 618-740 (1996) (Local Competition Order), aff'd in part and vacated in part sub nom. *Competitive Telecommunications Ass'n v. FCC*, 117 F.3d 1068 (8th Cir. 1997) and *Iowa Utils. Bd. v. FCC,* 120 F.3d 753 (8th Cir. 1997), aff'd in part and remanded, *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) *(Iowa Utils. Bd*.), on remand, *Iowa Utils. Bd. v. FCC,* 219 F.3d 744 (8th Cir. 2000), reversed in part sub nom. *Verizon Communications Inc. v. FCC*, 535 U.S. 467 (2002) (*Verizon*), Order on Reconsideration, 11 FCC Rcd 13042 (1996), Second Order on Reconsideration, 11 FCC Rcd 19738 (1996), Third Order on

Footnote continued on next page

bottleneck network elements would enable competitors to offer telecommunications services and would limit the market power of the ILECs.

Two specific UNEs, UNE-L and UNE-P, deserve special mention because of their market impact and importance to this proceeding. UNE-L, also known as "UNE Loop," consists of the loop from the central office to the customer's premise.[308] The purchase of a UNE-L by a competitive carrier enables the competitive carrier to reach a customer and serve the customer on its network. UNE-P, also known as "UNE-Platform," consists of a combination of the loop, port, and switching services of the ILEC. The purchase of the UNE-P enabled the competitive carrier to serve the customer with minimal network investment.

Entry into local carrier phone markets via UNE-P proved to be especially controversial. UNE-P largely displaced both resale and network investment:

> Competitive LECs' purchase of total service resale has declined from a peak of almost 5.4 million lines in 2000 to below 3.5 million lines by mid-2002. Over the same time period, total access lines served by UNE-Loops (UNE-L) and UNE-P combinations have grown from about 1.5 million to about 11.5 million. UNE-L grew from 1 million to 4 million lines. UNE-P lines grew from less than half a million to almost 7.5 million. These UNE-L and UNE-P represent approximately 6.9 percent of BOC [Bell Operating Companies] access lines. Competitive LECs provide service to about 16-20 percent of all access lines in the BOC territories: 26-33 percent of business access and about 9 percent of residential access lines. Considering all modes of entry, competitive LEC lines probably exceed 10 percent of BOC lines in most states. The BOCs at present

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Reconsideration and Further Notice of Proposed Rulemaking, 12 FCC Rcd 12460 (1997), further recons. pending. at 15812-72, paras. 618-740.

308 Historically, the major bottleneck to local phone competition was seen as the ILEC's control of "the last mile" between the central office to the customer's home.

> serve 87 percent of all incumbent LEC access lines while the "independent" incumbent LECs serve the balance.[309]

ILECs complained that UNE-P's forced "resale" strategy gave competitors a deep discount.

Various parties appealed the FCC's Triennial Review Order (TRO),[310] which established UNE rules pursuant to the Telecommunications Act of 1996, and these parties found relief in the D.C. Circuit Court's decision in *USTA II*.[311] Issued on March 2, 2004, the *USTA II* decision "vacated and remanded the nationwide impairment finding for mass market switching."[312] That is, the Court held that the FCC had not provided a sufficient rationale for its finding that competition by new entrants would be "impaired" throughout the nation if entrants lacked continued availability of switching, the key element of UNE-P.

As a consequence of the *USTA II* decision, the FCC decided to "revisit the unbundling obligations associated with several elements in a manner consistent with the *USTA II* decision and other controlling precedents."[313] In particular, based on the Court guidance, the FCC sought to determine when specific network elements "should be subject to unbundling under the revised [impairment] standard."[314] Under the revised impairment standard, the FCC had

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[309] TRO ¶ 41, footnotes omitted.

[310] See USTA II, 359 F.3d at 564-76. .

[311] USTA II, 359 F.3d at 564-76.

[312] TRRO ¶ 13.

[313] TRRO ¶ 29.

[314] TRRO ¶ 7, footnote omitted.

to "weigh the costs of unbundling and to examine whether the costs faced by competitive providers were due to natural monopoly characteristics or to the difficulties facing new entrants in all industries."[315]

The resulting Triennial Review Remand Order (TRRO) adopted a reduced number of unbundling requirements that it found necessary in order to avoid the impairment of local market competition.[316] Based on its analysis and new understanding of "impairment," the TRRO terminated the availability of UNE-P by removing "local circuit switching" from the list of network elements that ILECs must unbundle at TELRIC prices.[317] The FCC reasoned that multiple factors substantially mitigated the TRO's prior concerns about circuit switching impairment:

> [C]ompetitive LECs not only have deployed a significant, growing number of their own switches, often using new, more efficient technologies such as packet switches, but also that they are able to use those switches to serve the mass market in many areas, and that similar deployment is possible in other geographic markets. Additionally, we find that the BOCs have made significant improvements in their hot cut processes that should better situate them to perform larger volumes of hot cuts ("batch hot cuts") to the extent necessary.

Moreover, "regardless of any limited potential impairment requesting carriers may still face," the FCC held that "continued availability of

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[315] TRRO para 8.

[316] TRRO cited in footnote above.

[317] TRRO, p. 5

unbundled mass market switching would impose significant costs in the form of decreased investment incentives. . . ."[318]

The TRRO, however, did not modify the regulation that require that ILECs make available UNE-L to all competitors. It held that failing to provide access to UNE-L would impair competition. The prices for the UNE-L in California are set by this Commission at prices based on TELRIC studies of California-specific costs.[319]

In light of the TRRO decision and the analysis it relied upon, a central question for this proceeding is whether California can rely on the revised national unbundling scheme, which this Commission has implemented in the state, to check the market power of ILECs, or whether California should continue to impose additional regulations to protect California consumers from the market power of the carriers. Our following review of the position of parties demonstrates a significant dispute among parties over whether the federal program is sufficiently restricting ILEC market power. We nevertheless find that there is adequate evidence in the record to decide this matter at this time.

a) Verizon

Verizon argues that existing CLECs provide substantial competition for customers throughout Verizon's service territory. Although a formula links a wholesale price paid by resellers to an ILEC's resale price, Verizon maintains that "resold services nevertheless provide some competitive discipline on ILECs":

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[318] TRRO para 199.

[319] These stem from the Local Competition Order, cited above.

> Losing a customer to a reseller damages an ILEC in a more subtle and long-term sense than the short-run direct effect on revenues. Resellers can use resale as part of a larger strategy to migrate customers to their own facilities and/or to provide customers with a bundle of many telecommunications services. Once the ILEC loses the customer relationship to the reseller, the reseller can easily migrate the customer to its own facilities or to [Unbundled Network Element]-based provision when the facilities are ready.[320]

There are "CLECs serving 10,000 or more lines in 74 percent of 501 ZIP codes overlapping Verizon wire centers in California ("Verizon-area ZIP codes")."[321]

Verizon adds that the recent FCC TRRO decision that reduced the number of UNEs available to CLECs should not prevent CLECs from being viable competitors in the future.[322] It argues that this decrease in the number of UNEs was permitted, "because the FCC concluded that CLECs are not impaired without access to it at regulated rates. The fact that CLECs are not impaired without access to unbundled local switching at regulated rates means that reasonably efficient CLECs do not face entry barriers with respect to providing switching functionality.[323]

b) AT&T

AT&T declares that "[e]ven if intermodal competition were not flourishing, which of course it is, the availability of these legally mandated means for competitors to enter and expand in the communications market

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[320] Aron Opening Comments at ¶ 53.

[321] Verizon Opening Brief at 8.

[322] Aron Opening Comments at ¶ 57.

[323] Aron Reply Comments at ¶ 74.

constrain any market participant's ability to sustain prices above a competitive level."[324]

AT&T argues that legislative and regulatory action has dramatically reduced "the cost and risk of entry for competitors that can . . . choose among entry strategies – i.e., building facilities (based on a variety of technology platforms), leasing parts of the ILEC's network at regulated rates, or simply reselling existing retail services at economically efficient rates. . . ."[325] AT&T notes that "[s]ome CLECs target particular interests, such as Spanish-speaking customers or low income customers,"[326] and "[o]ther CLECs are primarily wholesale providers, offering services such as private line, fiber capacity, collocation, and network management to other carriers."[327] AT&T adds that "[s]ince 1996, CLECs have invested $75 billion in communications infrastructure, which positions them to compete not only for voice services, but also for broadband, data services, and VoIP."[328]

AT&T asserts that "the FCC's elimination of the UNE-P does not materially affect the ability of CLECs to compete."[329] AT&T maintains that "the FCC's determination to eliminate the UNE-P was based on the fact that CLECs are not impaired without mass market switching and UNE-P. In other words, an

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324 Pacific Bell Opening Brief at 16 (citing Taylor Opening Comments at 17-18).

325 Id.

326 Id. at 36 (citing Aron Testimony in 4 Tr. at 673-74).

327 Id. at 36 (citing Harris Opening Comments at 16).

328 Id. at 36 (citing Harris Opening Comments at 14).

329 Pacific Bell Reply Brief at 25.

efficient CLEC can enter economically."[330] It also observes that the FCC's Local Competition Report, issued in July 2005, "shows strong recent growth in both intermodal (coaxial cable) and intramodal fully facilities-based CLEC lines."[331]

c) SureWest/Frontier

SureWest asserts that CLEC competition is substantial in its territory. It notes a significant increase in trunks interconnected between SureWest and CLECs; the presence of 14 CLECs including AT&T, Verizon, XO, and Comcast; and the fact that cable providers Comcast and Starstream already pass nearly all homes in the area.[332]

Frontier claims that it faces significant competition from CLECs too. Disputing DRA's contention that "'Frontier was never required to provide UNE-P,'" Frontier replies that "[w]hile it is true that CLECs have not chosen to provide service in Frontier's territory using UNE-P, it is incorrect to say that Frontier was not subject to UNE-P requirements."[333] Frontier adds that "CLECs elected to compete in Frontier's territory through other channels" and that it has faced significant line losses to SureWest TeleVideo in Elk Grove.[334]

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330 Id. (citing Taylor Opening Comments at 19-21).

331 Id. (citing Taylor Reply Comments at 30-31).

332 SureWest Opening Brief at 17-18 (citing SureWest Opening Comments at 4-5; Opinion Approving Comcast CPCN Application, D.05-12-031. When a cable company "passes" a home, it stands ready to commence service to that home if the homeowner agrees to purchase its services.

333 Citizens Opening Brief at 6 (citing DRA Reply Comments at 80).

334 Id. (citing Exhibit 4).

d) DRA

DRA asserts that "there is little wireline-to-wireline competition today in California, and little reason to expect that type of competition to grow."[335] As evidence, DRA notes that "[t]otal service resale failed in California in 1997 after competitors entered the local market via resale, then quickly retreated,"[336] and that "many of the customers originally served via UNE-P have returned to SBC and Verizon" because of changes in court and FCC rulings.[337]

DRA does not recognize Cox's circuit-switched cable telephony offerings as viable competition either. Although it states that cable telephony is "reasonably comparable to the ILECs' basic exchange services,"[338] DRA maintains that cable telephony service "is expected to begin to fade away as the availability of VoIP services increases" as "Cox is in the process of migrating from circuit-switched cable telephony to VoIP.[339] DRA concludes that "the ILECs entirely dominate the provision of wireline and circuit-switched telephony."[340]

e) TURN

TURN rebuts mid-sized SureWest's and Frontier's claims that they face significant wireline competition. With respect to SureWest, TURN asserts that

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335 DRA Opening Brief at 20.

336 Id. (citing 2 Tr. at 244-247).

337 Id. (citing 2 Tr. at 248-250).

338 Id. at 23.

339 Id. at 23 (citing 2 Tr. at 261-263).

340 Id. at 21 (citing DRA Reply Comments at 55-59, 78-81; Roycroft Opening Comments at 6).

the company has "faced minimal CLEC entry since 1996."[341] TURN argues that SureWest "does not have a single competitor using a UNE loop or UNE-P in its territory, and there are approximately five customers purchasing resale service."[342] TURN adds that the "minimal competition" SureWest faces in the business market has not led to a lost of business lines for SureWest"; instead, TURN notes "increases in business lines for SureWest from 2004-2005."[343] With respect to Frontier, TURN argues that the company "maintains a pure monopoly position in the overwhelming majority of its wire centers."[344] TURN states that Frontier's "switched access lines increased from 2003-2004," and while its switched access lines "declined slightly" in 2004-2005, TURN notes that "there were substantial increases in Frontier's broadband connections."[345]

While acknowledging that "Verizon has faced greater competitive entry than Frontier and SureWest," TURN asserts that Verizon nevertheless "continues to dominate the provision of local exchange service within its California service area" and "does not face effective competition for its price-regulated wireline local exchange service."[346] As supporting evidence, TURN cites pre-MCI-merger HHI values of 7,875 and post-merger values of 8,412 for the residential market.[347]

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341 TURN Opening Brief at 8 (citing 4 Tr. at 710).

342 Id. (citing 5 Tr. at 749, 757).

343 Id. (citing Exhibit 51-C).

344 Id. (citing Roycroft Reply Comments at ¶12-15).

345 Id. (citing 4 Tr. at 710).

346 Id. at 9.

347 Id. (citing Roycroft Reply Comments (proprietary) at ¶22-23).

TURN adds that over 90% of Verizon's wire centers "have minimal or zero facilities-based CLEC competition for residential customers, with over 50% of these wire centers having no facilities-based competition at all."[348]

Finally, TURN argues that AT&T "retains an overwhelming market share for both the residential and small business market segments."[349] To reinforce this claim, TURN observes HHI values of 7,067 and 5,170 respectively pre-AT&T-merger, and 7,999 and 6,347 post-merger.[350]

f) DOD/FEA

DOD/FEA does not consider CLECs to be "effective" competitors. It cites several reasons for this lack of competition: (i) recent court and FCC decision that ended the availability of UNE-Platform rates;"[351] (ii) the AT&T/SBC and MCI/Verizon mergers; and (iii) the fact that "CLECs using UNE-LOOP . . . or resale strategies have not had significant success."[352]

g) DisabRA

DisabRA argues that there is a lack of "intra-modal" competition for disabled users.[353] It explains that "the disability-related services, products and support that the ILECs provide, particularly AT&T, are far superior to those

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348 Id. at 10 (citing Roycroft Reply Comments (proprietary)).

349 Id. (citing Roycroft Opening Comments at ¶67).

350 Id. (citing Roycroft Reply Comments at ¶30).

351 DOD/FEA Opening Brief at 5-6 (citing DOD/FEA Opening Comments at 3..

352 Id. at 6, citing DOD/FEA Opening Comments at 4.

353 DisabRA Opening Brief at 12-13.

provided by the CLECs and smaller providers."[354] Specifically, DisabRA notes that AT&T provides large print bill service, disability-specific customer service, and a "long list" of "accessibility services" that other competitors fail to provide.[355] DisabRA adds that "of all the individual consumers with disabilities whose stories were documented in the comments of DisabRA's Outreach Coordinator, . . not a single one of them purchased their telecommunications services from a non-ILEC."[356]

h) XO

XO asserts that there "are no geographic markets in which any ILEC faces significant competition in the provision of wholesale services to competitors and other carriers."[357] XO points out that CLECs' networks "do not even approach the scope and ubiquity of ILEC networks,"[358] and even "under the FCC's allegedly more targeted approach of requiring the existence of a minimum number of collocators as a prerequisite to special access pricing flexibility, the ILECs have consistently ***raised*** prices . . . where competition was supposed to exist."[359]

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354 Id. at 13.

355 Id. (citing Id. at Attachment 2, 2-3).

356 Id. at 14 (citing Id. at Attachment 3, ¶10-16).

357 XO Opening Comments at 5.

358 Id.

359 Id. at 9.

2. Position of Parties on Competition from Wireless

This section describes arguments relating to competition from wireless carriers. Parties commenting on this topic include the following: Verizon, AT&T, SureWest, DRA, TURN, DOD/FEA, DisabRA, Greenlining, and CSBRT/CSBA.

a) Verizon

Verizon argues that "[t]he record shows that wireless is leading this intermodal assault on incumbents in California, with wireless cannibalization being the 'key killer' of primary consumer lines."[360] Verizon observes that there has been an inverse relationship between the number of wireline customers and the number of wireless customers: Verizon states that in California the number of landline phones decreased by 1.57 million from year-end 2001-2004, while the number of wireless subscribers increased by 6.52 million.[361]

More to the point, Verizon states "that wireless substitution accounts for *approximately half of ILEC primary residential wireline losses*, as wireless providers improve the reach of their networks and customers exhibit a growing willingness to 'cut the cord.'"[362] Verizon further references a number of studies that describe

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[360] Verizon Opening Brief at 10.

[361] Aron Opening Comments at ¶ 62 (citing Local Telephone Competition: Status as of June 30, 2004, Federal Communications Commission, Industry Analysis and Technology Division Wireline Competition Bureau, December 2004, downloaded from http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom1204.pdf, Tables 8 (CLEC Lines), 9 (ILEC lines), and 13 (wireless)).

[362] Verizon Opening Brief at 10 (emphasis in original) (citing Aron Reply Comments at ¶ 72).

the negative impact of wireless on the wireline market. These studies include one by Loomis and Swann that finds that five percent of telephone customers are "cutting the cord,"[363] a study by the Census Bureau (2004), and a study by In-Stat/MDR (2004).[364] Verizon adds that a report by Sprint indicates that twenty-two percent of Sprint's wireless customers use their wireless phone as their primary phone.[365]

Verizon's future projections similarly show a slow but increasing shift from wireline to wireless technologies. It cites surveys showing that nine percent of adults use wireless service exclusively, with thirty-nine percent of wireline customers "very" or "somewhat" likely to abandon wireline phone service within two years.[366] Verizon cites another study that estimates that nearly thirty percent of wireless subscribers will not have a landline by 2008.[367]

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363 Aron Reply Comments at ¶ 22 (citing David G. Loomis, and Christopher M. Swann, Intermodal Competition in Local Telecommunications Markets, Information Economics and Policy, Vol. 17 (2005)).

364 Aron Opening Comments at ¶ 63 (citing Clyde Tucker et al., Household Telephone Service and Usage Patterns in the U.S. in 2004, Bureau of Labor Statistics at Table A, 4); In-Stat/MDR, Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution, 2004.

365 Aron Reply Comments at ¶¶ 27, 118 (citing Yuki Noguchi, Sprint Prepares to Cut the Cord, Washington Post, June 6, 2005).

366 Harris Reply Comments at 16 (citing Nearly One in Ten U.S. Adults Use Wireless Phones Exclusively and Landline Displacement Expected to Grow, Harris Interactive, June 27, 2005; Consumers and Communications Technologies: Current and Future Use, Harris Interactive, prepared for the National Consumers' League, June 29, 2005).

367 Aron Opening Comments at ¶ 63 (citing Clyde Tucker et al., Household Telephone Service and Usage Patterns in the U.S. in 2004, Bureau of Labor Statistics at Table A, 4); In-Stat/MDR, Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution, 2004.

b) AT&T

AT&T considers wireless service to be a substitute for wireline service. The ILEC presents significant further evidence that demonstrates that consumers are substituting wireless service for wireline service, in terms of total dollars spent and cord cutting:

> The number of wireless subscribers has surpassed wireline end user switched access lines, and American households spend more today on mobile wireless service than on traditional wireline local and long distance service combined. . . .[368]
>
> [O]ne recent survey revealed that nine percent of adults use wireless service exclusively, an additional five percent are "seriously considering" abandoning wireline service, and almost half are considering it. Further, even as many customers are choosing to use wireless service exclusively, many more customers are choosing to own both wireline and wireless phones and shift their usage between them in response to price changes. . . . [369]

AT&T adds that "[w]ithin five years, it is estimated that 20 percent of all mobile wireless users will have discontinued wireline service."[370] All told, this market evidence leads AT&T to conclude that the "complete

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[368] Pacific Bell Opening Brief at 25-26 (citing Harris Opening Comments at 18).

[369] Id. at 13-14 (citing Harris Opening Comments at 19-23; Harris Reply Comments at 16).

[370] Id. at 27 (citing Harris Opening Comments at 22-23).

substitution of wireless for wireline service is unnecessary to impose strong market discipline on wireline pricing."[371]

AT&T declares that "[s]mall and mid-sized businesses . . . rely heavily on mobile wireless service" too.[372] The large ILEC cites a recent survey that found that "78 percent of small business owners use mobile wireless services and three-fourths of these consider mobile service to be 'essential' or 'important' to their business operations."[373]

c) SureWest

SureWest asserts that it directly competes with nine wireless telephone carriers. including Sprint/Nextel, T-Mobile, Verizon Wireless, Cingular, and Metro PCS.[374] SureWest notes that some wireless and VoIP plans, which are currently available in its service area, are competitively priced with SureWest's basic residential access line service.[375] Thus, SureWest views wireless as a competing technology.

d) DRA

DRA argues that "for many customers wireless service is not a substitute for wireline service."[376] DRA asserts that "mobile wireless service is not actually

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[371] Id. at 13-14.

[372] Id. at 28.

[373] Id. at 28 (citing Harris Opening Comments at 23).

[374] SureWest Opening Brief at 18-19.

[375] Id. at 19.

[376] DRA Opening Brief at 25 (citing 3 Tr. at 521-522).

competition at all, but is instead merely a different ILEC service that the ILECs market to customers, often using the same personnel and provided over some of the same facilities as their wireline services."[377] According to DRA, AT&T admitted as recently as December 2005 that "it [wa]s not aware of any evidence showing that wireless service is a substitute for wireline service."[378]

DRA also rebuts claims of competition in the business service market. DRA notes that "the ILECs' evidence rarely addresses intermodal competition from wireless services for *business* services at all,"[379] and alleges that a Verizon witness agreed "that wireless phones are not a close substitute for wireline phones for most small businesses."[380]

e) TURN

TURN argues that wireless service is a complement, rather than a substitute to, local exchange service.[381] TURN cites a study "showing that cord cutting activity was slowing over time, and which found that cord cutters are not

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377 Id. at 26 (citing ORA Reply Comments at 28-30).

378 Id. at 25 (citing Exhibits 11 and 12).

379 Id. at 26.

380 Id. at 26 (citing ORA Reply Comments at 30; Exhibit 1, A.05-02-027, SBC Response to TURN 11-41 Public.pdf).

381 TURN Opening Brief at 12. In support of this argument, TURN states that AT&T expert Harris "agrees that wireless is currently a complement to local exchange service, not a substitute." TURN Opening Brief at 14, citing RT. 326. This assertion, however, seems to be an overstatement. Harris, in fact, states the following: "When a customer increases use of wireless, the customer is not necessarily replacing minutes of use in the home. . . . If that family decided to spend more on telecommunications services, this could be due to the family actually buying additional services instead of substituting." Id. at 14 (citing 2 Tr. at 332-334).

representative of the total population of telecommunications users, but . . . are young and in a low income bracket."[382] It also notes two additional studies – one that reveals "evidence regarding the relationship between wireline and wireless service," and another that concludes that "wireless service does not impose a pricing constraint on ILEC market power."[383]

According to TURN, there are a number of "compelling reasons as to why very few customers have actually cut the cord."[384] TURN states that wireless plans "bill for usage for both incoming and outgoing calls," their "ergonomics . . . are not suitable for all portions of the population, . . . such as the elderly or those with physical disabilities," and wireline use "is necessary for a variety of complementary technologies, including home security systems, satellite television systems, and digital video recorders."[385] TURN also asserts that wireless telephones "do not provide a reasonable means of Internet access."[386] Given these considerations, TURN concludes that wireless service is "currently a poor substitute for local exchange service."[387]

Moreover, TURN contends that ILECs overstate the competitive impact of the small percentage of wireline customers who have migrated over to wireless-

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[382] Id. at 13 (citing 4 Tr. at 674; Roycroft Reply Comments at ¶ 73).

[383] Id. at 13 (citing Roycroft Opening Comments at ¶ 132).

[384] Id. at 14.

[385] Id. at 14-15 (citing Roycroft Opening Comments at ¶114; Exhibit 44).

[386] Id. at 15.

[387] Id. at 14.

only service.[388] TURN notes that "ILECs such as Verizon, SBC and SureWest have wireless affiliates and are well positioned in the wireless market."[389] For example, TURN observes that in SureWest territory "over a five-year period, very few subscribers ported wireline numbers to wireless," but that "[o]f these, the vast majority of business customers and a majority of residential customers ported their wireline numbers to SureWest's wireless affiliate."[390]

f) DOD/FEA

DOD/FEA does not consider wireless effective competition, since "only a small percent of end users have found it appropriate to 'cut the cord' and rely on wireless for their basic service needs."[391]

g) DisabRA

DisabRA asserts there is a lack of intermodal competition, because "many of the potential alternatives to wireline service that are available to some Californians are simply not real choices for many Californians with disabilities."[392] It declares that "adaptive equipment only works with wireline service"[393]: "'[A]ll equipment installed by DDTP [the Deaf and Disabled Telecommunications Program] is only compatible with standard, land-line

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388 Id. at 13 (citing Aron Opening Comments at ¶ 67).

389 Id. at 13 (citing Roycroft Reply Comments at ¶ 62; Roycroft Opening Comments at ¶123-126).

390 Id. at 8-9 (citing Roycroft Reply Comments at ¶19).

391 DOD/FEA Opening Brief at 6 (citing DOD/FEA Opening Comments at 4).

392 DisabRA Opening Brief at 14.

393 DisabRA Opening Brief at 15 (citing Id. at Attachment 3, ¶ 6).

telephone equipment.'"[394] According to DisabRA, "alternative services are not accessible," because of the reach and dexterity problems of certain disabled citizens,[395] as well as poor design and marketing by providers.[396] DisabRA adds that "wireline service provides greater security" for those with increased dependence on emergency medical service.[397] It alleges that "E-911 . . . comes standard with wireline phones, but is not available with either VoIP or wireless."[398] Finally, DisabRA contends that "alternative services and adaptive devices are prohibitively expensive," because people with disabilities have disproportionately low incomes[399], "services . . . are not covered under the state's DDTTP program,"[400] and adaptive equipment is expensive.[401]

h) Greenlining

Greenlining states that wireless may play a dual role for consumers. On the one hand, Greenling argues that wireless service can be a complement to landline service: Because of E911, fax service, broadband service, "maintain[ing] an alarm system," and "clearer reception and more reliable service than a cellular

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394 Id. (citing Id. at Attachment 3, ¶ 6).

395 Id. at 15-16 (citing Id. at Attachment 3, ¶16).

396 Id. at 15 (citing Id. at Attachment 2, 10 and 13).

397 Id. at 17 (citing Id. at Attachment 2, 3-4).

398 Id. (citing Id. at Attachment 2, 3-4).

399 Id. at 19 (citing Id. at Attachment 2, 4).

400 Id. (citing WS-3 Tr. at 253).

401 Id.

phone," "[c]ommon sense indicates that people won't give up their landline unless they have to."[402] On the other hand, Greenlining declares that wireless service also can be a substitute to landline service: "[P]eople who cannot afford a home and, as renters, move more frequently, 'find' cell phone service cheaper and easier than the installation costs and inconvenience of obtaining landline service with every move."[403]

According to Greenlining, most people, however, would prefer for their wireless service to be merely a complement to wireline service. Greenlining asserts that substitution typically is forced: "Personal experience tells us that people who are cutting the cord are often forced to because of unfavorable financial situations and if given the money and a more stable living arrangement, they would also choose a landline."[404] Greenling fears that "[t]his situation will be aggravated if new regulation results in increased wireline prices for low-income users. . . ."[405] It urges the Commission "to avert forced substitution and insure the safety and technologic inclusion of low-income consumers."[406]

i) CSBRT/CSBA

CSBRT/CSBA asserts that "[a]s prices for wireless services drop and the level of wireless services improves, consumers are substituting wireless service

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[402] Greenlining Opening Brief at 8.

[403] Id.

[404] Id. at 8-9.

[405] Id. at 13.

[406] Id.

for local exchange and long distance service from traditional wireline carriers."[407] It cites an FCC report that includes statistics on the increased usage of wireless, and the decreased usage of wireline:

> 23 percent of voice minutes in 2003 were wireless, up from 7 percent in 2000. . . . [The] effects [of mobile telephone] include a decrease in the number of residential access lines, a drop in long distance revenues, and a decline in payphone profits. In 2003 these trends continued, with the four largest LECS losing 4 percent of their access lines, and wireline long distance voice revenues declining further. One analyst stated that "wireless cannibalization remains a key driver of access line erosion."[408]

CSBRT/CSBA notes that the wireline market in the United States, as compared to other countries, is particularly ripe for wireless competition: "Wireless minutes of use per subscriber in the U.S. are already 3.7x higher than in Europe, providing evidence that wireless is much more of a full voice replacement.[409] Additionally, CSBRT/CSBA states that it expects for the competitive advantage of wireless service to increase, as wireless service providers further cut prices and improve their service quality.[410]

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407 CSBRT/CSBA Opening Comments at 2.

408 Id. (citing Implementation of Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services (CMRS), Ninth Report (2004) at 89).

409 Id. at 3-4 (citing Frank Governali, et al., Neutral Views Retained for North American Telcos, Goldman Sachs, (January 12, 2005) at 5).

410 Id. at 3-4 (citing Frank Governali, et al., Neutral Views Retained for North American Telcos, Goldman Sachs, (January 12, 2005) at 5).

3. Position of Parties on Competition from VoIP and Cable, Including Cable VoIP

This section discusses competition from VoIP and cable services, including cable VoIP. Parties commenting on this topic include the following: Verizon, AT&T, DRA, TURN, and CSBRT/CSBA.

a) Verizon

Verizon declares that "[t]he record shows that VoIP poses an even greater threat to ILECs because its going-forward growth projections are nothing short of staggering."[411] Stating that VoIP already provides cross-platform competition, Verizon documents the extensive services provided by VoIP providers today, as well as the estimates by industry analysts of its growth potential.[412]

Verizon explains that this potential growth is driven by the widespread availability of broadband. In support of this assertion, it cites this Commission's own analysis, which shows that broadband is available in one hundred percent of all California ZIP codes, and that eighty-seven percent of the ZIP codes are served by two or more broadband providers.[413] Verizon adds that the FCC has documented the increase in broadband access too:

> According to the FCC, from June 2000 to June 2004, California's broadband market *expanded by fully 416%*, growing from 900,000 to just over *4.69 million* broadband lines. In fact, California has the most broadband subscribers of any state in the nation, with almost as many broadband subscribers as the two states (New York and

[411] Verizon Opening Brief at 12.

[412] Id. at 13.

[413] Id. at 12 (citing Aron Opening Comments at ¶ 99).

> Florida) with second and third highest levels of broadband subscription *combined*.[414]

Verizon's own expert produced an analysis that found that "one or more VoIP providers (not including Verizon's VoiceWing service) [are] offering local (NPA) telephone numbers associated with *every Verizon wire center except one.*"[415]

In particular, Verizon argues that cable television companies pose a significant threat to its wireline business. The ILEC reviews a round-up of cable data from around the country that documents cable's rapid growth in telephony markets.[416] For example, a Berstein Research study estimates "that by the end of 2006, *64%* of U.S. households will have the option of purchasing VoIP telephony service from their cable companies. . . ."[417] Verizon notes that Cox already has achieved "a *40%* telephony penetration in Orange County, California."[418]

According to Verizon, cable companies face relatively low barriers to entry when joining the telephony market:

> For a cable provider to offer telephony requires little additional sunk cost once the network has been enabled for broadband, an upgrade that *almost every MSO in California has already performed*, according to the Commission's 2005 Broadband Report. Indeed, that report

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414 Id. at 13 (emphasis in original).

415 Id. (emphasis in original) (citing Aron Opening Comments at ¶ 102; Aron Reply Comments at ¶ 59).

416 Id. at 17-18.

417 Aron Reply Comments at ¶ 72 (citing Craig Moffett et al., Quarterly VoIP Monitor: How High is Up for Cable VoIP?, Bernstein Research Call, March 24, 2005; Harris Opening Comments at 27 (citing same)).

418 Aron Reply Comments at ¶ 65 (citing Cox Brings Telephone to Five New Markets in '05, Cox Communications Press Release, March 8, 2005).

> showed that cable plant is *nearly ubiquitous* in California, with cable providers passing approximately *97%* of households with television service in California.[419]

Verizon references testimony and studies that observe that cable telephony is one of the "*easiest products cable MSOs can add to their product base*," with the incremental cost of deploying telephony services estimated at less than $300 per household, and the operating break-even point below $20 per month."[420] Verizon states that Cox need only expend *$267* per household to add a VoIP customer.[421]

b) AT&T

AT&T contends that "VoIP services are an increasingly significant competitive alternative to traditional wireline services."[422] The ILEC reminds the Commission that, as with wireless, "the appropriate question is not whether VoIP and traditional wireline services are identical, but whether some customers would shift from one to the other if prices changed."[423] Moreover, AT&T asserts that Cox and other cable companies already provide many of the features some parties allege are limited to wireline service, and "in this competitive market,

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419 Verizon Opening Brief at 15 (citing Aron Reply Comments at ¶ 114).

420 Id. at 16 (citing Aron Reply Comments at ¶ 71).

421 Aron Reply Comments at ¶ 72 (citing Voice over Internet Protocol: Ready for Prime Time, Cox Communications' Successful Deployment of VoIP, Cox Communications white paper, May 2004, at 11).

422 Pacific Bell Opening Brief at 14 (citing Harris Opening Comments at 25-28; Harris Reply Comments at 18-22).

423 Pacific Bell Opening Brief at 14 (citing Taylor Reply Comments at 12-13).

[more services] would be offered by other VoIP providers if consumers demanded them."[424]

Like Verizon, AT&T notes that VoIP growth is being fueled by increased access to and usage of broadband. AT&T cites a recent Commission report that notes "over 90 percent of households in California have access to broadband service today and over 35 percent of households currently subscribe to cable modem or DSL."[425] AT&T further references estimates that "within just three years, over 60 percent of California households will have broadband service,"[426] and that "by the end of next year, nearly two-thirds of households in the U.S. will have the option to purchase VoIP service from their cable company."[427] AT&T explains that "because VoIP is significantly less costly to deploy and maintain than circuit-switched telephony, VoIP offerings are exerting downward pressure on voice service prices."[428]

424 Harris Reply Comments at 20-21 (citing Cox website, accessed 8/19/2005, available at www.cox.com; Whitepaper: Voice over Internet Protocol: Ready for Prime Time, Cox Communications, May, 2004; Comcast website, accessed 8/19/2005, available at www.comcast.com; Time Warner Cable website, accessed 8/16/2005, available at www.timewarnercable.com).

425 Id. at 18 (citing Broadband Deployment in California, CPUC (May 5, 2005) at 7).

426 Id. at 18 (citing Harris Opening Comments at 52).

427 Id. at 18-19 (citing Harris Opening Comments at 27).

428 Id. at 20.

c) DRA

While considering it a "somewhat more difficult call," DRA nevertheless concludes that VoIP services should not be included in the relevant market.[429] DRA explains that statistics from the E911 database are evidence that "there is relatively little cable-based VoIP competition in California today,"[430] and "cable-based VoIP may be missing entirely in some markets."[431] DRA also notes that "regulatory or other changes . . . might . . . lead to failure of this mode of competition."[432] Alternatively, even "if this specific option flourishes," DRA states that competition from VoIP alone may not exert significant pressure on wireline service prices.[433] DRA contends that VoIP's entry in the voice market may merely "result in a duopoly telecommunications market . . . that may continue to require some regulatory oversight."[434]

DRA is particularly unimpressed by stand-alone VoIP services, such as Vonage, that are not affiliated with a broadband service provider. It argues that these services "are even less comparable to the ILECs' wireline basic exchange services."[435] DRA reasons that "the FCC *excluded* such services from the product market definition for mass-market (residential and small business) basic

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[429] DRA Opening Brief at 23.

[430] Id. (citing ORA Reply Comments at 22, 31, 45).

[431] Id. at 24 (citing ORA Reply Comments at 34-35).

[432] Id. (citing ORA Reply Comments at 32).

[433] Id. (citing ORA Reply Comments at 32).

[434] Id. (citing ORA Reply Comments at 32).

[435] Id. at 25 (citing ORA Reply Comments at 36-38).

exchange services in its two recent merger decisions,"[436] and the ILECs' "own affiliates have been relatively unsuccessful in providing stand-alone VoIP."[437]

d) TURN

TURN contends that "cable telephone service providers . . . have made minimal inroads into the local exchange markets served by SBC, Verizon, SureWest and Frontier."[438] It declares that "circuit-switched (and any VoIP) lines provided by Cox in California have been accounted for in the competition analysis undertaken by TURN and DRA/ORA," and this analysis indicates the ILECs retain high market concentration.[439] In contrast, TURN alleges that the ILECs fail to "offer any evidence whatsoever about the actual extent of [VoIP] competition in California."[440]

e) CSBRT/CSBA

CSBRT/CSBA declares that broadband access allows consumers to "substitute Voice over Internet Protocol (VoIP) services for traditional local exchange and inter-exchange services,"[441] and current developments indicate that more and more consumers will switch to VoIP:

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[436] Id. at 24-25 (citing FCC SBC/AT&T Merger Order, ¶88; FCC Verizon/MCI Merger Order, ¶89).

[437] Id. at 25 (citing DRA Reply Comments, at 36-38).

[438] TURN Opening Brief at 18.

[439] Id.

[440] Id. (citing Aron Opening Comments at ¶83-84).

[441] CSBRT/CSBA Opening Brief at 4 (citing CISCO Systems Reports Third Quarter Earnings, May 10, 2005 at http://newsroom.cisco.com/dlls/2005/fin_051005.html?CMP=ILC-001; Linksys Ships

Footnote continued on next page

> On May 10, 2005, Cisco Systems, as part of its most recent earnings statement, reported that its Lynsys Division shipped one million VoIP ports to the consumer market in six months. These products, bundled with a VoIP service, enable customers to make phone calls using their broadband connection. One analyst forecasts that VoIP by cable operators "will eventually take upwards of 20% market share of primary residential access lines." [442]

CSBRT/CSBA adds that many consumers already have access to technology necessary to support VoIP usage: "As of mid-2004, the FCC reports that there are over 4.6 million DSL, coaxial and other high speed lines (over 200 kilobits per second in one direction) in California with the number of high speed lines increasing by over 35% a year."[443]

4. Positions of Parties on ILEC Market Power

This section discusses the summary statements of parties on whether ILECs have market power and should therefore continue to be constrained by pricing regulations. Parties commenting on this topic include the following: Verizon, AT&T, DRA, TURN, DisabRA, CPA, Greenlining, and Cox.

Over One Million Voice Over IP Ports to the Consumer Market in Less Than 6 Months, May 10, 2005 at http://www.linksys.com/press/press.asp?prid=199&cyear=2005; Frank Governali, et al., Neutral Views Retained for North American Telcos, Goldman Sachs, (Jan 12, 2005) at 4).

[442] Id. (citing CISCO Systems Reports Third Quarter Earnings, May 10, 2005 at http://newsroom.cisco.com/dlls/2005/fin_051005.html?CMP=ILC-001; Linksys Ships Over One Million Voice Over IP Ports to the Consumer Market in Less Than 6 Months, May 10, 2005 at http://www.linksys.com/press/press.asp?prid=199&cyear=2005; Frank Governali, et al., Neutral Views Retained for North American Telcos, Goldman Sachs, (Jan 12, 2005) at 4).

[443] Id. (citing High Speed Access for Internet Access: Status as of June 30, 2004, FCC Industry Analysis and Technology Division, Wireline Competition Bureau (December 2004) at Table 8).

a) Verizon

Verizon concludes that it no longer possesses market power that would warrant continuation of current pricing regulations:

> Based on a broad range of Commission and FCC reports, government surveys, industry publications, financial analyst reports, competitive forecasts, and econometric studies, the record provides substantial evidence showing the ease with which intermodal competitors can continue to enter the market and constrain prices going forward. This analysis is consistent across all types of intermodal providers – wireless, VoIP, and cable.[444]

More specifically, Verizon provides maps of the presence of CLECs, wireless, and cable providers of telephony service throughout Verizon's territory. These maps demonstrate what Verizon calls the ubiquitous availability of CLEC, cable, and wireless alternatives in Verizon's California service territory.[445]

Verizon cites recent findings by the FCC and the California Commission as further evidence of the importance of intermodal competition.[446] In particular, Verizon notes that "[i]n the Verizon-MCI and SBC-AT&T merger orders, the FCC concluded that facilities-based VoIP services "clearly fall within the relevant

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444 Verizon, Opening Brief at 10.

445 Id. at 8.

446 Id. at 18. Verizon cites the Commission "Intermodal competition, principally from cable, wireless, and … VoIP[,] is intensifying in the mass market in California. Intermodal alternatives have displaced and are continuing to apply competitive price pressure on and continuing to displace a significant amount of traditional wireline service and usage." D.05-11-029 (Nov. 18, 2005), Finding of Fact 25 at p. 121; see also D.05-11-028 (Nov. 18, 2005), Finding of Fact 22 at p. 104.]

service market for local services."[447] Verizon also notes that "[t]he FCC found that the same was true for wireless, to the extent that customers rely on it as a complete substitute for wireline service, adding 'intermodal competition between wireless and wireline service will likely increase in the near term.'"[448]

b) AT&T

AT&T likewise maintains that competition is present in all voice markets. Specifically, Harris, testifying on behalf of AT&T, criticizes the idea that "a consumer gets the benefits from competition only if that individual is offered and takes advantage of several competitive choices."[449] Harris asserts that this characterization "is just plain wrong," because "competition at the margins (i.e. competition for small groups of customers) can provide widespread benefits to consumers, even to those who do not have the options."[450]

AT&T declares that its position regarding the presence of intermodal competition is substantiated by the "intensive antitrust review and regulatory scrutiny" of the SBC/AT&T merger.[451] AT&T explains that the reviews of the merger included "extensive discovery into the very same communications

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447 Id. (citing FCC 05-184 (Verizon-MCI Merger Order), WC Docket No. 05-75, Rel. Nov. 17, 2005 at ¶¶ 87, 90–91; FCC 05-183 (SBC-AT&T Order), WC Docket No. 05-65, Rel. Nov. 17, 2005 at ¶¶ 87, 89–90).

448 Id. at 19 (citing FCC 05-184 (Verizon-MCI Merger Order), WC Docket No. 05-75, Rel. Nov. 17, 2005 at ¶¶ 87, 90–91; FCC 05-183 (SBC-AT&T Order), WC Docket No. 05-65, Rel. Nov. 17, 2005 at ¶¶ 87, 89–90).

449 Harris Opening Comments at 12.

450 Id. at 12.

451 Pacific Bell Opening Brief at 36.

markets that are the subject of this proceeding,"[452] and the U.S. Department of Justice (DOJ), California Attorney General (AG), FCC, and this Commission each found the use of HHI to be of "little value" to these reviews.[453] AT&T adds that the DOJ subsequently "concluded that the transaction will not harm competition and will likely benefit consumers, due to existing competition, emerging technologies [and] the changing regulatory environment.'"[454] According to AT&T, the California AG supported this conclusion too.[455]

c) DRA

DRA claims that "the most recent available data" indicates that AT&T's and Verizon's dominance in the market for basic exchange services "is *increasing*."[456] According to DRA, market share data reveal that "SBC's dominance of intrastate telecommunications services is rapidly extending from basic local exchange services into wireless, long-distance and even Internet access services,"[457] and "Verizon's market shares generally are either constant or increasing."[458] DRA cites HHI numbers, using Verizon and AT&T data, as evidence that residential service and basic exchange business service markets are

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452 Id. at 36.

453 AT&T Opening Brief, at 37.

454 Id.

455 Id.

456 DRA Opening Brief at 28 (citing ORA Reply Comments at 55-56, 78-84).

457 Id. at 28-29 (citing Exhibit 17; Exhibit 1).

458 Id. at 30 (citing Exhibit 57C).

"highly concentrated."[459] DRA also relies upon "wallet share" data from third-party vendor TNS Telecoms to show that SBC and Verizon – even in an "extremely overbroad market definition" including local, long distance, wireless, cable, and Internet – control a substantial share of the market.[460]

DRA also questions whether new intermodal competition will place any material pricing pressure on the ILECs. It maintains that much of current "substitution is the result of the ILECs' deliberate efforts to market and co-market their own wireless services,"[461] so "it is premature to conclude that the ultimate result will be increased competition as opposed to merely an equally concentrated market made up of different services."[462] DRA further argues that "even when total 'cord-cutting' occurs, . . . it is concentrated among younger customers who might not otherwise subscribe to phone service at all, or in the past, would have shared one line in a household with multiple occupants."[463]

Finally, even assuming intermodal competition exists and exerts significant pressure on the ILECs, DRA still voices doubts whether the Commission should make changes to its price regulations. DRA explains that "to the extent that the ILECs have shown they are suffering any loss to competition, they have not shown that anything about the current regulatory framework is

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459 Id. at 29 (citing ORA Reply Comments at 57).

460 Id. at 34-35 (citing ORA Reply Comments at 48; Exhibit 1 thereto at SBC-CA Response to ORA 2-6, RROIR 000605-6; Exhibit 62C, at 104; Exhibit 62C, at 4).

461 Id. at 38 (citing ORA Reply Comments at 29-30, 51-52 and 78).

462 Id. at 41.

463 Id. at 37-38 (citing ORA Reply Comments at 27).

driving that loss.[464] DRA adds that "as heavy users switch in even greater numbers to bundles and higher-end services such as DSL . . . it will become a greater and greater temptation for the ILECs to maximize profit by shifting maintenance and other resources away from basic switched service customers."[465]

d) TURN

TURN maintains that ILECs continue to have significant market power. With respect to SureWest and Verizon, TURN states that its analysis found that "market concentration little changed from the pre-1996 period, with virtual monopoly conditions persisting in most wire centers."[466] TURN asserts that Frontier "maintains a pure monopoly position in the overwhelming majority of its wire centers,"[467] and that AT&T "retains an overwhelming market share for both the residential and small business market segments."[468]

TURN's analysis of market competition, however, relies on its conclusion that the relevant market only includes wireline circuit switched telecommunications services.[469] Based on this determination, TURN relies on a HHI analysis of the narrow wireline telecommunications service.

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[464] Id. at 41 (citing 2 Tr. at 357-359).

[465] DRA Opening Brief at 37.

[466] TURN Opening Brief at 7 (citing Roycroft Reply Comments at ¶¶14, 17, 20, & 31).

[467] Id. at 8 (citing Roycroft Reply Comments at ¶12-15).

[468] Id. at 10 (citing Roycroft Opening Comments at ¶36).

[469] Id. at 7 (citing Roycroft Reply Comments at ¶¶14, 17, 20, & 31).

e) DisabRA

DisabRA expresses concern that the disabled market will not invite competition, because it is perceived to be an "unattractive sub-market:"

> [B]ecause of the difficulty in marketing to people with a range of disabilities, and because many people with disabilities are low income, providers may ignore this market in order to pursue market segments that are seen as more lucrative.[470]

Testifying on behalf of DisabRA, Dmitri Belser adds that "many service providers in California have been unwilling to offer accessible and disability-related services and products because of their perceptions, right or wrong, about the disability market."[471]

f) CPA

CPA agrees with "the very experienced and highly qualified economists representing a cross-section of interests – DRA, SBC and DOD" who state that "typical pay telephone locations are not likely to be sought after or served by the ILECs' facilities-based competitors."[472] CPA explains that since "payphone lines are rarely concentrated"[473] and are typically "located on the premises of a gasoline station, a corner grocery, a neighborhood restaurant, or another small business,"[474] the lack of "proximity of such small businesses to a larger business

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470 DisabRA Opening Brief at Attachment 2, 5.

471 Id. at 20 (citing Id. at Attachment 2, 5).

472 CPA Opening Brief at 7.

473 Id. at 6.

474 Id. at 5 (citing Murray Testimony in 5 Tr. at 856).

customer that is a target for a competitor's investment in 'overbuilding' the ILEC's investment" makes competition unlikely.[475] It adds that pay telephones are important to rural areas and low-income and minority neighborhoods,[476] all places where competition is likely to develop more slowly than other areas.[477]

g) Greenlining

Greenlining concludes that AT&T and Verizon "completely dominate their respective markets."[478] According to Greenlining, the ILECs' market capitalization of over $90 billion each supports this conclusion.[479] Greenlining adds that AT&T and Verizon "have and will be able to maintain their dominance due to knowledge of consumers' demands, a well-established corporate infrastructure, strategic marketing techniques, and smart business decisions – such as mergers and buyouts of competition."[480] Greenlining asserts that the ILECs "have successfully been able to parlay landline losses into broadband and wireless profits due to the strengths of their respective corporations."[481]

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475 Id. at 5-6 (citing Harris Testimony in 2 Tr. 253-260, 3 Tr. 471-472).

476 Id. at 5 (citing Murray Testimony in 5 Tr. 856).

477 Id. at 5 (citing Murray Testimony in 5 Tr. 856).

478 Greenlining Opening Brief at 10 (citing The New York Times, Huge Phone Deal Seeks To Thwart Smaller Rivals, (March 6, 2006)).

479 Id. (citing The New York Times, Huge Phone Deal Seeks To Thwart Smaller Rivals, (March 6, 2006)).

480 Id.

481 Id. (citing Exhibit 47; SBC's "Earning Releases" for 1st, 2nd, 3rd, and 4th Quarters of 2005 available on SBC's website).

h) Cox

Cox states that the ILECs' "arguments do not support the claims of losses due to 'intermodal' competition from other companies."[482] It questions the applicability of ILECs' studies to California, because "much of their 'evidence' on line losses was national in scope, not focused at all on California."[483] But even assuming the ILECs are losing lines, Cox doubts the importance of these losses, since by "the ILECs' candid admissions . . . much of the line losses . . . were . . . conversions of their own customers from traditional landline services to other forms of service still provided by them."[484] Cox suggests that losses "are offset by gains by the ILECs in DSL lines and wireless lines."[485] Evidence offered in support of this conclusion includes the following: an AT&T customer briefing,[486] Harris's testimony that AT&T's "decline in residential access lines was, in fact, being more than offset by [its] increase in broadband access lines,"[487] and Taylor's testimony that "losses in access lines were, in large number, losses to broadband and wireless services."[488]

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[482] Cox Opening Brief at 9.

[483] Id. at 8.

[484] Id.

[485] Id. at 9 (citing 3 Tr. at 495-496).

[486] Id. (citing Exhibit 10).

[487] Id. (citing 2 Tr. at 348).

[488] Id. (citing 3 Tr. at 495-496).

5. Discussion: ILECs Do Not Possess Market Power that Warrants Continuation of Current Regulations

Our review of the extensive record in this proceeding convinces us that Verizon, SBC, SureWest, and Frontier lack the ability to limit the supply of telecommunications services in telecommunications markets, and therefore lack the market power needed to sustain prices above the levels that a competitive market would produce. We find that this result holds throughout their service territories and for both business and residential services.

Verizon takes the most direct approach in presenting its case. First, Verizon detailed how the FCC's ubiquitous unbundling regulatory strategy has led to the widespread entry of CLECS into local markets and, by ensuring provision of a reasonably priced UNE-L, makes all markets subject to unbundling requirements contestable. Second, Verizon demonstrated how advanced technologies act as close substitutes to wireline services. Verizon reviewed the impact this cross-platform competition is having on the sale of telecommunications services. Finally, Verizon documented the presence of competitive suppliers throughout its entire service territory.

Verizon appropriately began by discussing the federal unbundling scheme, which was implemented over multiple years by the FCC and this Commission and remains in place today. Verizon described the unbundling strategy as follows:

> The mandated sharing of the incumbent's network, via resale and unbundling, enables competitors to use the incumbent's facilities in competition with the incumbent, while being able to profitably charge a price equal to regulated wholesale price of the unbundled

> network elements plus a competitively determined cost for marketing and customer service.[489]

Verizon argued that these obligations imposed on incumbents, if satisfied, "render retail regulation unnecessary and redundant."[490]

Although the existence of this regulatory policy alone assures that we do not need the level of price regulation adopted eighteen years ago when competition was not present, Verizon also successfully demonstrated that this program has led to the actual entry of competitors into telecommunications markets. Verizon produced evidence that CLECs are present in zip codes that represent ninety percent of the total households in Verizon's service territory.[491] The presence of these CLECs, along the continued provision of UNE-L at wholesale prices set by this Commission, makes it possible for CLECS to contest any market in which Verizon attempts to raise prices above just and reasonable levels. We find this cumulative evidence to be persuasive.

In addition to demonstrating the efficacy of policies to limit market power and ensure just and reasonable rates, Verizon further showed that wireless and VoIP communications are competitors to wireline telecommunications services. As described above, Verizon demonstrated that wireless telecommunications services are a close substitute for wireless services. Verizon provided survey data that indicate the large portion of communications users see wireless communications as a substitute for wireline communications, and it

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489 Aron Opening Comments at ¶ 166.

490 Aron Opening Comments at ¶ 166.

491 Aron Reply Comments at ¶ 58, directly cited above.

demonstrated that the availability of this technology has led to the losses of lines to wireless service.[492] Verizon established that that "wireless substitution accounts for *approximately half of ILEC primary residential wireline losses*, as wireless providers improve the reach of their networks and customers exhibit a growing willingness to 'cut the cord.'"[493]

We agree that the build out of wireless carriers' networks since this Commission's last major telecommunications regulatory review eighteen years ago has made wireless technologies a close substitute for landline services. This evidence is a significant factor in this decision.

In addition, Verizon's evidence, especially when coupled with data produced by AT&T (reviewed below), convincingly establishes that a competitive threat is offered by the new VoIP technologies too. First, there is little doubt that VoIP is a close substitute for wireline service, particularly in light of recent FCC action requiring VoIP communications providers to furnish E-911 services to its customers.[494] Second, Verizon confirmed that it is possible for various firms to provide VoIP service to a large number of consumers. It noted that, as of June 2004, there already were 4.69 million broadband lines in California,[495] and many Californians subscribe to broadband service.[496] Third,

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[492] Verizon Opening Brief at 10 (citing Aron Reply Comments at ¶ 92).

[493] Id. (emphasis in original) (citing Aron Reply Declaration at ¶ 72).

[494] VoIP E911 Order, 20 FCC Rcd at 10266. We further note that pending federal legislative proposals would require VoIP providers to contribute to the Universal Service Fund in a manner that is similar to the wireless carriers and other telecommunications providers.

[495] Verizon Opening Brief at 13 (citing Aron Opening Comments at ¶ 26).

Verizon verified that there are "one or more VoIP providers (not including Verizon's VoiceWing service) offering local (NPA) telephone numbers associated with *every Verizon wire center except one*."[497] Fourth, and most significantly, Verizon demonstrated that there are no material barriers to entry that limit the ability of a VoIP provider to offer service. Verizon documented that it is possible to add a VoIP customer for an incremental investment of less than $300, a fraction of the investment needed to provide circuit switched service.[498]

Verizon next builds upon its prior arguments by presenting a map that shows the ubiquitous competitive presence of wireless carriers, CLEC wireline carriers, and cable service providers present within its service territory.[499] This testimony, which documents the presence of cross-platform competitors throughout the entire Verizon service territory in California, is uncontroverted.

In summary, Verizon has developed a record in this proceeding that demonstrates that policy, technology, and market developments prevent it from exercising market power in its California service territories. The extensive presence of competitors in Verizon's service territory and the ease of expanding service by both wireless and VoIP carriers makes it clear that Verizon could not limit the supply of telecommunications services provided in any part of its California service territories and thereby cannot sustain above-market prices.

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[496] Id.

[497] Id. (emphasis in original) (citing Aron Opening Comments at ¶ 102; Aron Reply Comments at ¶ 59).

[498] Id. at 16 (citing Aron Reply Comments at ¶ 71).

[499] Aron Reply Comments at 39.

AT&T's showing likewise demonstrated that policy and technology limit its market power. Like Verizon, AT&T states that under Sections 251(c) and 252(d) of the Telecom Act of 1996, it must "provide unbundled network elements (UNEs) at cost-based rates, resell retail services at an avoided cost discount, and interconnect with competitors' networks using cost-based reciprocal interconnection charges."[500] This Commission has spent countless hours in fulfilling the state duties required to implement these sections of the Telecommunications Act of 1996.[501] As a result, the Commission is intimately familiar with this regulatory program, and our experience is consistent with both ILECs' characterization of the unbundling regime.

AT&T, like Verizon, also detailed the growth of wireless and VoIP services. AT&T documented that alternative technologies have provided realistic alternatives to wireline telecommunications service: "[D]uring the period 2000-2004, SBC California lost almost 19 percent of its residential switched access lines, including a loss of over 21 percent of its non-lifeline primary residential switched access lines. During the same period, SBC California lost almost 23 percent of its business switched access lines."[502] Testifying on behalf of AT&T, Harris provided further evidence that shows wireless, even when purchased in addition to a wireline connection, places competitive pressure on landline services:

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500 Pacific Bell Opening Brief at 16 (citing Taylor Opening Comments at 16-17).

501 For example, this Commission recently completed the tasks of pricing unbundled network elements that these carriers must make available to any company seeking to enter its market.

502 Pacific Bell Opening Brief at 61.

> [A]t least occasionally, almost three fourths of wireless subscribers use a wireless phone instead of a wireline phone for long distance calls, and 65 percent do so for local calls. The same study also finds that 39 percent of wireline phones users are "very" or "somewhat" likely to abandon their wireline service within two years.[503]

Thus, AT&T demonstrated that wireless technology already exercises a competitive check on AT&T's provision of telecommunications services.

Concerning VoIP, AT&T showed that major competitors, such as Cox, are using this technology to provide voice communications services.[504] AT&T confirmed that a large number of California consumers have access to VoIP: AT&T cites a recent Commission report that notes "over 90 percent of households in California have access to broadband service today and over 35 percent of households currently subscribe to cable modem or DSL."[505] Verizon's further demonstrations regarding ease of entry and ubiquity of broadband access are relevant for AT&T too.

While AT&T does not follow Verizon's lead and demonstrate the ubiquitous presence of competitors throughout its service territory, AT&T nonetheless has convincingly demonstrated that competitive forces limit market power. In particular, AT&T's central argument – that the unbundling scheme makes the provision of telecommunications services by competitors possible in every wire center throughout its service territory – is compelling.

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[503] Pacific Bell Opening Brief at 28 (citing Harris Reply Comments at 16).

[504] Harris Reply Comments at 18-19.

[505] Id. at 18 (citing "Broadband Deployment in California," CPUC, at 7 (May 5, 2005)).

Testimony regarding SureWest and Frontier convinces us that the market power of these mid-sized ILECs is similarly limited. SureWest's market power is restricted by unbundling scheme adopted by the FCC, the presence of six wireless carriers in its service territory, and developments in VoIP technology. Frontier likewise showed that it is subject to unbundling requirements and it faces competition from wireless and VoIP technologies. CSBRT/CSBA gave us further evidence that wireless technology competes with wireline technology for the provision of communication minutes. The small business groups provided testimony that wireless has arrived as a competitive telecommunications technology, and convincingly cited an FCC study that concludes that wireless technology has led to "a decrease in the number of residential access lines, a drop in long distance revenues, and a decline in payphone profits." [506]

We find that arguments of other parties that contend there is little competition and that the incumbent carriers retain market power are unpersuasive. These contrary arguments are not supported by the weight of the substantial record evidence, including the evidence that these parties themselves marshaled.

TURN and DRA define the market for telecommunications services narrowly, and focus a large part of their analysis on wireline services. They then assert that local telecommunications markets lack meaningful competition in this

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[506] CSBRT/CSBA Opening Comments at 2 (citing Implementation of Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services (CMRS), Ninth Report (2004) at 89).

narrowly defined market.[507] We are not persuaded by this narrowly focused analysis. As our prior discussion has made clear, the relevant market is voice communications services regardless of technology, not just traditional wireline communications services. Arguments made by TURN and DRA fail to rebut the arguments of the ILECs on this point.

DRA's evidence that a CLEC entry strategy based on UNE-P failed does not support its conclusion that an ILEC could sustain an above-market price increase. A loss of UNE-P is irrelevant to whether an ILEC can increase its prices. UNE-P never provided real incentives for true facilities-based competition, so its demise will not have a negative impact on the level of competition in the telecommunications market.

Indeed, some parties even suggest that the elimination of UNE-P may lead to *increased* competition in the telecommunications market, which would further limit ILECs' market power. In the En Banc hearing, the Commission learned from the witness Hazlett that, in his view, the unbundling strategy pursued by the FCC not only failed in providing a competitive alternative, but it also discouraged investment in facilities that compete with ILECs in the provision of telecommunications services.[508] In the evidentiary portion of this proceeding, Aron filed testimony on behalf of Verizon that makes similar points.[509] Aron explained that UNE-P was "severely underpriced" relative to ILECs' actual

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507 See DRA Opening Brief, p. 20 ; TURN Opening Brief, p. 9. Note that TURN's HHI calculations ignore competition from wireless carriers.

508 See En Banc Transcript in R.05-04-005 June 27, 2005, TR pp. 31-55

509 Aron Opening Comments at ¶ 60.

costs,[510] that this pricing led to "a ravaging of the incentive to invest in facilities,"[511] and that "where retail prices are low relative to cost or even below cost, competition is discouraged."[512] Aron's testimony is uncontroverted.

HHI values cited by TURN and DRA also provide no helpful information for our assessment of ILEC market power. As noted above, TURN and DRA have calculated HHIs based on their narrow definition of the telecommunications market (excluding all wireless services) and argue that high values of the HHI that they calculate indicate that this market is highly concentrated.[513] They then conclude that the incumbents have market power.[514]

This reliance on HHI calculations, however, is neither legally nor economically justified. Substantial legal precedent discusses the dangers of relying on market share as a measure of competition in regulated markets.[515]

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[510] Id. at ¶ 56.

[511] Id. at ¶ 56.

[512] Id. at ¶ 59.

[513] DRA Opening Brief, p. 20; TURN Opening Brief, p. 9;

[514] Id.

[515] See generally In the Matters of Petition for Forbearance of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160 (c), WC Docket No. 01-338; SBC Communications Inc.'s Petition for Forbearance Under 47 U.S.C. § 160 (c), WC Docket No. 03-235; Qwest Communications International Inc. Petition for Forbearance Under 47 U.S.C. § 160 (c), WC Docket No. 03-260; BellSouthTelecommunications Inc. Petition for Forbearance Under 47 U.S.C. § 160 (c), WC Docket No. 04-48; Memorandum and Opinion and Order, Released October 27, 2004 ("Section 271 Forbearance Order"), ¶ 22, n. 66; United States v. General Dynamics Corp., 415 U.S. 486, 498 (1974) (market share is imperfect measure of competitive constraints and must be examined in light of access to alternative supplies); Time Warner Entertainment Co. v. FCC, 240 F.3d 1126, 1134 (D.C. Cir. 2001) (stating, in discussing competition to cable systems, that "normally a

Footnote continued on next page

Such dangers are well recognized by the courts, the FCC, and this Commission. For example, in dismissing a claim that a cellular phone company with a one hundred percent share of the wholesale market exercised market power, the Ninth Circuit stated:

> "Blind reliance upon market share, divorced from commercial reality, [can] give a misleading picture of a firm's actual ability to control prices or exclude competition. . . ." Reliance on statistical market share in cases involving regulated industries is at best a tricky enterprise and is downright folly where, as here, the predominant market share is the result of regulation. In such cases, the court should focus directly on the regulated firm's ability to control prices or exclude competition.[516]

In its 1996 order declaring that the long distance carrier AT&T was non-dominant, the FCC agreed that "it is well-established that market share, by itself, is not the sole determining factor of whether a firm possesses market power":

> Other factors, such as demand and supply elasticities, conditions of entry and other market conditions, must be examined to determine whether a particular firm exercises market power in the relevant market. As [the FCC] noted in the First Interexchange Competition Order, "[m]arket share alone is not necessarily a reliable measure of

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company's ability to exercise market power depends not only on its share of the market, but also on the elasticities of supply and demand, which in turn are determined by the availability of competition"); Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, 11 FCC Rcd 3271, 3308, ¶ 68 (1995) ("market share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities") (quoting Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Order, 6 FCC Rcd 5880, 5890, ¶ 51 (1991)).

[516] Metro Mobile CTS, Inc. v. New Vector Communications, 892 F.2d 62, 63 (9th Cir. 1989).

> competition, particularly in markets with high supply and demand elasticities."[517]

Similarly, this Commission, in analyzing the merger of Verizon and MCI, held that it agreed with the Advisory Opinion that HHI analysis "does not provide relevant insight into the dynamics of this market, and is not needed to perform a competitive analysis."[518] Thus, legal precedent indicates that HHIs are not needed for our analysis of whether a company can sustain prices above market.

From an economic standpoint, the market share analysis provided by TURN and DRA is meaningless for evaluating market power in the telecommunications market. Market share tests are inherently backward looking and not good predictors of future developments, particularly in a rapidly changing industry like telecommunication. Technological changes are occurring rapidly and are impacting the market for traditional telephone service. For example, U.S. VoIP subscribership had reached 2.7 million in mid-2005 – a six-fold increase from the prior year – and is expected to continue to grow rapidly.[519] In addition, wireless carriers now compete in offering voice communications services.[520] DRA's and TURN's market share analyses do not reflect these developments. Indeed, their HHI figures completely exclude any consideration of competition from wireless or VoIP providers. Thus, both the rapid changing

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517 Id.

518 Decision 05-11-029, at 5/2

519 Aron Reply Comments at ¶ 40

520 Aron Reply Comments at ¶44.

technological environment and the overly narrow market definition combine to make the HHI figures calculated by TURN and DRA meaningless for our analysis of the market situation.

The assertions of TURN and DRA that wireless services complement wireline services are not supported by the evidence. When services are complements, then the increased use of one service leads to the increased use of the other. Thus, if the arguments of TURN and DRA that wireline and wireless services are complements were true, we would expect that the increasing use of wireless phones would lead to an increasing use of wireline phones. However, by all measures presented in the evidence, the increasing use of wireless services is correlated with decreasing use of wireline services.[521] Neither TURN nor DRA addresses these facts that are inconsistent with their principal arguments. If wireline and wireless are indeed complements, TURN and DRA should be documenting increases in the use of wireline service, yet they are instead arguing that the decreases are small. The treatment of wireless is particularly critical to the arguments of TURN and DRA, and the exclusion of wireless from HHI leads to inflated values.

With respect to VoIP, DRA states that "the ILECs themselves do not really consider this mode a viable form of long-term competition and that their own affiliates have been relatively unsuccessful in providing stand-alone VoIP."[522] Our review of the record evidence cited by DRA does not lead to the same finding. While we see that ILECs so far have not been successful in their VoIP

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[521] Id.

[522] DRA Opening Brief at 25.

offerings,[523] we find no record support for the proposition that ILECs do not consider stand-alone VoIP a viable form of long-term competition. In fact, as chronicled previously, Verizon and AT&T submitted testimony stating that they consider VoIP to be a substantial long term competitor.

Concerning the comments of other parties, we are not persuaded by Cox's argument that we should not view the local market as competitive, because ILEC line losses largely resulted from DSL conversion, not intermodal competition.[524] We find that the testimony of Aron, Verizon's witness, convincingly demonstrated that VoIP has tremendous growth potential, due to the explosive growth rate of 416% in the California broadband market between 2000 and 2004 to 4.69 million broadband lines.[525] The summary statement that specifically predicts that "[o]ver the next five years, we project the Bells will lose at least as many lines to VoIP as they have lost to UNE-P over the previous five years – but those lost to VoIP will generate zero revenue for the Bells and, therefore, have far worse margin implications" comports with our own view of this market.[526]

The testimony of XO, unfortunately, focused on a special access service not considered in this phase of the proceeding.

Greenlining's arguments suggesting that wireless service may be a complement to wireline service for some customers and a substitute for others

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523 Id.

524 Cox Opening Brief, at. 8-10

525 Verizon Opening Brief at 13.

526 Verizon Opening Brief, at 15, citing citing Jeffrey Helpern, and Shing Yin, "U.S. Wireline: Access Line and DSL Trends Take a Turn for the Worse, with Seasonality Only Partly to Blame," Bernstein Research Call, August 12, 2005, p. 1.

are clearly true.[527] For our analysis here, however, what is critical is the *net effect*, and we find that the record evidence as a whole convincingly shows that wireless service overall is a substitute for wireline service.

DisabRA made a showing based on the assumption that the services used by their disabled constituents are special and differ from the mass market communication services.[528] We agree with this assessment, but that showing is not critical to our inquiry in this more generic proceeding. The special services used by the disabled community instead are being addressed in a separate rulemaking proceeding, which looks at the public policy programs targeted at both the LifeLine and disabled communities.[529]

CPA argued that voice services connecting pay telephones are share the characteristic of those traditional landline services proposed for special pricing protections, such as basic residential and business services.[530] Yet the decline in pay telephone use, largely as a result of ubiquity of wireless services, demonstrates that it is indeed subject to competitive forces that make price controls unnecessary. Moreover, other remedies for pay telephone providers are available, and will continue to be available, under our regulatory regime. If pay telephone companies face a "price squeeze" for inputs that they need, they may have cause for complaint. We note that wholesale services are not part of this proceeding.

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[527] See Greenling Opening Brief at 7-9.

[528] DisabRA Opening Brief at 1.

[529] R.06-05-028.

[530] CPA Opening Brief at 9.

DOD/FEA's arguments largely lament the demise of the UNE-P.[531] The demise of the UNE-P resulted from a FCC strategy, and as we discussed above, this demise does not materially affect our assessment of ILEC market power.

In addition to the comments and testimony directly discussed, we have reviewed the entire record on this matter and conclude that Verizon, SBC, SureWest, and Frontier lack market power in their service territories. We, therefore, conclude that price regulation is no longer needed to ensure that prices are just and reasonable.

Finally, recognizing public controversy associated with this proceeding, we briefly discuss what we do *not* need to demonstrate to establish a lack of market power. First, we do not need to find that a telecommunications market is "perfectly competitive." No market is perfectly competitive, but many markets are disciplined by threats of entry and the availability of close substitutes, which check the pricing power of market participants.

Second, we do not need to demonstrate the loss of significant market share to competitors by the incumbent carriers. In all markets, competition takes place "at the margins," and competition results from the ability of firms at the margins to increase their production to take advantage of market opportunities. Although a loss of market share demonstrates low market power, market share loss is not necessary to demonstrate a loss of market power.

In summary, our analysis finds that the ubiquity of the FCC unbundling policies limits the market power of AT&T, Verizon, SureWest, and Frontier. Cross-platform competition, particularly that from wireless and VoIP

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531 DOD/FEA Opening Brief at 5.

technologies, provides an additional check that reduces market power of each carrier. Also Verizon and SureWest have demonstrated the presence of competitors throughout their entire service territories. Thus, a geographically specific analysis of policy and competitors makes clear that the ILECs no longer possess market power. In the sections that follow, we will apply the law and these findings on market power to determine reasonable regulatory policies.

VI. Basic Residential Rates: Impact of CHCF-B

Currently, the Commission generally sets telecommunications rates for any single carrier based on the carrier-wide costs associated with its operations. While no statute requires a uniform state rate for basic residential service, California policy recognizes that telecommunications costs vary by region, and the state has used geographically averaged rates and created programs to "reduce" this "disparity in rates."[532]

Even this policy approach, however, has exceptions. Rates for basic service vary substantially across carriers. Verizon has two basic rates depending on exchange, and within AT&T service territories, a proliferation of EAS services create a disparity in the "basic rate."

While we continue to require geographically averaged rates, the Commission has recognized the "merits of . . . the adoption of geographically deaveraged LEC retail rates" for quite some time.[533] The Commission announced its intention to develop geographically unfettered rates as far back as ten years

[532] § 793.3 states that the purpose of the program is "to reduce any disparity in rates charged by those companies" – namely, the 17 small independent telecommunications carriers that provide service in California.

[533] D.96-03-020 (1996 Cal. PUC LEXIS 257, 29-30 (Cal. PUC 1996)).

ago.[534] This development, however, was stalled by a desire to first wait "until the appropriate pricing studies are concluded."[535] With market competition in its infancy, the Commission supposed it would need to establish geographic areas, conduct cost studies in each area, and establish a price for the ILEC that offered retail service in each area. It is not surprising that the Commission never approved geographically unfettered prices, given the complexities of conducting cost and pricing studies that the Commission then deemed necessary.

The first major policy issue we address today is whether we now should permit geographically unfettered pricing for telecommunications services. If adopted wholesale, the policy reform would permit ILECs to engage in unfettered pricing of all services in each geographic region that it defines. Expressed in the record are many intermediate positions that would allow unfettered pricing for specific services, such as business services, or in particular places, such as on lines not receiving a geographically-based California High Cost Fund B (CHCF-B) subsidy. Consequently, our forward-looking policy must determine both whether and to what extent to permit geographically unfettered prices.

A. Position of Parties

AT&T, the largest ILEC, supports the complete elimination of all requirements controlling the prices of telecommunications services.[536] AT&T

[534] [JPK: need lookup] D.96-03-020 (1996 Cal. PUC LEXIS 257, 29-30 (Cal. PUC 1996)).

[535] [JPK: need lookup] D.96-03-020 (1996 Cal. PUC LEXIS 257 (Cal. PUC 1996))

[536] Pacific Bell Opening Brief at 58 (stating that "market forces must be allowed to operate unimpeded by outmoded regulatory restrictions on prices, promotions and introducing new services").

would do away with, among other regulations, price rules that would require geographically averaged pricing.[537] AT&T characterizes its proposed policy reform as "full pricing flexibility."[538] In AT&T's view, lack of this full pricing flexibility prevents "efficient facilities-based competition,"[539] and its proposed reform would more closely align "costs and prices."[540]

Verizon joins AT&T in its support of geographically unfettered prices. Verizon states that under its proposal, "[f]ull geographic deaveraging would be permitted."[541]

Frontier endorses a similar policy reform. The mid-sized ILEC argues that "[p]ricing flexibility for non-basic services should include the ability to deaverage prices geographically."[542] Frontier points to current pricing practices in support of this proposal:

> Costs are not uniform throughout all of California or over all of Frontier's large and diverse service area, and there is no reason for prices for competitive services to be the same by regulatory fiat. The record is clear that California already has deaveraged prices for telecommunications services depending upon the service provider that a customer is either assigned to or chooses. . . . Customers have already accepted[ed] deaveraging, and would be prepared to accept

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537 Id. (declaring that "carriers should be free to offer geographically deaveraged prices").

538 Id. at 58-59.

539 Pacific Bell Reply Comments at 41.

540 Pacific Bell Reply Brief at 48-49.

541 Verizon Opening Brief at 3.

542 Citizens Opening Brief at 21.

> a more market-based, cost-based version of deaveraging in the future, should companies elect or be compelled by competition to move in that direction."[543]

According to Frontier, its proposed policy reform would merely build upon other geographically-based telecommunications prices already allowed in California.

DRA supports geographically unfettered pricing, but only with certain conditions. DRA would permit only "downward" price revisions – meaning price decreases but no price increases – and only after the Commission completes an investigation of "the high-cost fund subsidy levels."[544] DRA contends that "it would be fundamentally inconsistent with the move toward a more uniform framework and would be unfair to potential competitors to allow the ILECs to deaverage basic service rates while they are still receiving subsidies to maintain affordable basic service rates in high-cost areas"[545]:

> Competitive issues aside, allowing upward deaveraging in combination with CHCF-B subsidies would also pervert the very purpose of providing high-cost funds and would likely harm those ratepayers in outlying areas who are far less likely to have access to competitive options. Moreover, given that small ILEC Lifeline service rates are keyed to SBC's existing basic service prices, allowing SBC to increase its basic service prices for some (but not all)

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[543] Id.

[544] DRA Opening Brief at 6 n. 5. As mentioned previously, the Commission has initiated a rulemaking on CHCF-B in R.06-05-028.

[545] DRA is referencing the fact that the large ILECs receive CHCF-B subsidies for high cost areas.

> residential customers would complicate the determination of permissible Lifeline service rates outside SBC's service territory.[546]

Consequently, DRA, at this time, opposes any grant of authority to increase prices for basic rates, which in turn would limit the ILECs' ability to have non-geographically averaged rates other than through downward price movements.

Cox, a competitor not subject to geographic pricing limitations, likewise opposes geographically unfettered pricing for ILECs. Cox claims that price freezes are needed to prevent "ILECs from engaging in anticompetitive pricing":

> The ILECs' insistence on downward pricing flexibility for subsidized services, along with the right to engage in geographical deaveraging for bundles and promotions (as AT&T and Verizon have proposed), discloses their goals. They intend to use the high-cost subsidies to fund their targeted price reductions, offering lower prices on subsidized services where they face the most inroads from competitive entrants. Customers who have no competitive alternatives will continue to see higher prices, which (combined with the [C]HCF-B funds) will help the ILECs with their continued efforts to block competition from every angle.[547]

Given these concerns, Cox concludes that it is "absolutely essential that the Commission resolve the issue of high-cost subsidies before it allows the ILECs to have downward pricing flexibility."[548] Cox asserts that the Commission, in particular, should "make certain that it has competed its analysis of the subsidy issues" before permitting downward pricing

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546 DRA Reply Brief at 25. Note SBC in now AT&T.

547 Cox Opening Brief at 19.

548 Id.

flexibility for basic residential service and geographically targeted promotions.[549]

TURN lends further support to the argument that "the Commission should deny authority for geographic deaveraging at this time."[550] TURN contends that there is "insufficient evidence in the record to allow this Commission to conclude that rates will remain 'just and reasonable' if it adopts any of the deaveraging proposals. . . . The 'record' on deaveraging in this proceeding, including all comments, briefs and workshop transcripts, amounts to perhaps 5 double spaced pages, if that."[551] TURN finds the arguments made by AT&T, Frontier, and Verizon unpersuasive.

B. Discussion: Public Policy Programs Make Geographically Unfettered Pricing Inappropriate in Certain High-Cost Areas

As described in Section III above, federal and state statutes require that our regulations should promote competition in the telecommunications marketplace; use competitively and technologically neutral policies to encourage development of a wide choice of new technologies and services; and ensure continued support for social policies embodied in the statutes. This section applies this statutory guidance and finds that the current policy of geographically averaged prices fails to meet the major statutory goals for this proceeding.

First, the current policy of geographically averaged prices is inconsistent with a competitive marketplace. This policy made more sense in a past

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549 Id. at 20.

550 TURN Reply Brief at 40.

551 TURN Reply Brief at 44.

monopoly era, where universal service subsidies were applied to the monopolist's high cost areas. As AT&T correctly observes, only a policy that permits prices to move towards costs is consistent with "efficient facilities-based competition."[552] A requirement of geographically averaged prices could lead to the provision of services by high-costing but subsidized technologies, while discouraging service by low-costing but unsubsidized services. As an example, in many rural areas, it may prove less expensive to provide dial tone telephone service via wireless technologies than by subsidizing the construction of long copper wire traditional telephone service connections.

Second, the policy of geographically averaged prices is not applied in a technologically and competitively neutral fashion. The policy requirement only applies to California ILECs, and not to cable carriers, wireless carriers, or the new VoIP companies. Consequently, the policy puts the traditional landline telephone carriers subject to this requirement at a significant disadvantage vis-à-vis their competitors. For the ILECs, the geographically averaged prices policy requires them to price communications services above costs in urban areas where traffic and population densities cause costs to be low; at the same time, ILECs must provide services at prices below costs in areas where low densities lead to high service costs. The policy of geographically averaged prices effectively prevents ILECs from competing with other providers on a level playing field. As a result, the policy discourages, rather than encourages, fair competition in the telecommunications marketplace.

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[552] Pacific Bell Reply Comments at 41.

Finally, when considering reforms to price regulation, we cannot overlook our third policy goal: to continue to support social policies embodied in statutes. The requirement of uniform prices across geographic areas currently is inextricably linked to our CHCF-B program, which acts to subsidize service in ILECs high cost fund areas. Surcharges placed on wireless phone bills are used to subsidize wireline services provided by carriers of last resort (COLRs) that provide services in areas where costs exceed $20.30 for basic residential service. VoIP consumers, under our current rules, do not have to pay the surcharge. Offsetting competitive disadvantages of price controls, ILECs receive approximately $450 million in CHCF-B subsidies for their provision of residential wireline telephone services in areas where costs exceed the $20.30 cutoff level.[553] The policy of geographically averaged prices, in conjunction with the CHCF-B program, supports the continued affordability of telecommunications services in high-cost areas where the costs of providing services exceed the prices charged. The program enables connections to our landline telephone system at artificially low rates for important universal service reasons. We believe it would be contrary to the Legislature's intent if we no longer required CHCF-B subsidized services to be offered at geographically averaged prices.

At the same time, however, we recognize that even the statute creating CHCF-B has its limits. Pursuant to Public Utilities Code § 739.3, we set a rate that ensures high-cost areas are sufficiently subsidized through CHCF-B. Offering high-cost services at a price lower than the mandated below-cost rate

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[553] CPUC Resolution T-16883, adopted October 28, 2004.

infringes upon our first policy goal, to encourage reliance on a competitive marketplace. While we do not share Cox's concern with anticompetitive pricing,[554] we agree that ILECs should not be able to manipulate markets by offering special promotions that price CHCF-B subsidized services even further below the already below-cost rate specified by the Commission. Thus, we find that both a price floor and a price ceiling are necessary to ensure appropriate pricing for CHCF-B subsidized services.

We, however, find that no other statutory social policy applies to the question of whether telecommunications services should be geographically unfettered. Neither CHCF-B nor any other social policy program is directly implicated by unsubsidized services.

C. Discussion: Market Conditions Indicate Geographically Unfettered Pricing Is a Reasonable Policy in the Absence of CHCF-B Subsidies

Given the absence of a statutory constraint, we now turn to whether market conditions make unfettered pricing a reasonable policy for services that are not subsidized by CHCF-B. This review requires us to consider pricing power of the ILECs in this proceeding.

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[554] Predatory pricing is unlawful, and remains so whether or not the Commission permits geographically unfettered pricing. A company engages in predatory pricing when it sets the price of its services or goods very low, in order to eliminate its competitors and prevent new competitors from entering into the marketplace. Also the existence of the CHCF-B subsidies does not affect the economic rewards or costs that arise from a policy of predatory pricing. These subsidies only allow a carrier to recover actual costs it incurs while providing below-cost services; they provide no excess profits that may be used to support a policy of predatory pricing. Thus, we see no economic link by which the CHCF-B transfers encourage predatory pricing.

As we established in Section V, the evidentiary record in this proceeding demonstrates that current competition or the threat of market entry exists throughout the ILECs' service territories. We find that FCC-mandated unbundling policies; the required provision of stand-alone DSL service by Verizon and AT&T; and substantial cross-platform competition sufficiently restrain incumbents' pricing power. Market conditions do not present an obstacle to usage of unfettered pricing in the absence of subsidies imposed to promote specific social policies.

Indeed, allowing geographically unfettered pricing for telecommunications services not supported by CHCF-B may *improve* market competition and the supply of telecommunications services in rural areas. Our current policy of requiring geographically averaged pricing may encourage an oversupply of wireline services in a high-cost areas – that is, the geographic averaging requirement may promote use of high-cost services when an efficient market might provide similar services with a lower-cost technology (such as wireless or VoIP services).

In conclusion, we find that neither statutory directives nor market conditions warrant continuation of our geographically averaged pricing policy for services that are not subsidized by CHCF-B. We, therefore, remove the geographic averaging requirement for all services other than CHCF-B subsidized basic residential service. We also lift this requirement for all bundled services that do not include CHCF-B subsidized basic residential service.

We, however, hold that pricing restrictions remain necessary should the basic residential services rate be supported by CHCF-B subsidies. CHCF-B subsidies are market-distorting, and thus broader pricing freedoms requested by the ILECs are imprudent. Thus, we order that basic residential services receiving a CHCF-B subsidy shall be frozen at a level equal to the geographically averaged rate, which will be reevaluated in our upcoming CHCF-B review in R.06-06-028. By adopting this price freeze, we effectively create both a price floor and a price ceiling for basic residential service rates that are supported by CHCF-B subsidies.

VII. Basic Residential Rates: Impact of LifeLine

California's basic residential phone service rates are priced among the lowest in the country.[555] For AT&T, basic residential flat rate service is $10.69 per month, while for Verizon, it is $16.85 or $17.25 per month, depending on the exchanges served.[556] For SureWest, the tariffed rate for basic flat rate residential service is $18.90.[557] For Frontier, the tariffed rate is $17.85.[558] The rate for basic residential phone service, therefore, varies by seventy-seven percent, depending on the carrier providing the phone service. The Commission has found through

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[555] The low price of California residential services, particularly those provided by AT&T, is well known to all regulators and has been tracked by the FCC for some time. See, e.g., *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service*, prepared by Paul R. Zimmerman of the Industry Analysis and Technology Division of the FCC's Wireline Competition Bureau (Washington: FCC, 2005) (Table 1.4 show that for 94 cities throughout the United States, the cities of Anaheim, Bakersfield, Fresno, Los Angeles, Oakland, Salinas, San Diego and San Francisco are tied for the lowest rate in the national sample. Of the California cities sampled, only Long Beach and San Bernardino do not have the lowest rates in the nation.).

[556] Pacific Bell, Tariff Schedule CAL. P.U.C, A-5, 6th Revised Sheet 21; Verizon California, Tariff Schedule CAL. P. U. C. A-1, 37th Revised Sheet 10.2.

[557] SureWest Telephone, Tariff Schedule CAL. P.U.C. NO. A3. Roseville, California 3rd Revised Sheet 1.

[558] Citizens Telecommunications Company, Tariff Schedule CAL. P.U.C. A-1, 5th Revised Sheet 1.

its regulatory proceedings that all of these different rates qualify as "reasonable" rates for basic residential service.

These basic residential rates currently are set by Commission order. Carriers can neither decrease nor increase the rate charged for this service. In addition to the pricing issues that arise concerning the primary residential line, similar issues arise concerning secondary residential phone lines.

A. Position of Parties

Most parties in this proceeding make a specific proposal concerning the pricing of basic residential services. No party calls for immediate upward pricing flexibility for primary residential lines or other services they consider basic, but there is significant variation among the various parties' proposals.

AT&T proposes "to cap temporarily the current rate for primary line basic residential service because of its relation to funding and administration of public policy programs."[559] Although it maintains that market conditions "justify full pricing flexibility for all residential services,"[560] AT&T proposes that this cap be in effect for "a transitional period ending not later than June 1, 2007, . . . to allow the public policy program issues to be resolved."[561] During this proposed transitional period, downward pricing flexibility would be allowed for all

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559 Pacific Bell Opening Brief at 62. AT&T specifically proposes that this cap would apply to 1 Flat Rate ("1FR"), 1 Measured Rate ("1MR"), and where applicable, Extended Areas Service ("EAS") rates." See Opening Brief at 62 n. 229.

560 Id. (citing Harris Opening Comments at 53-54).

561 Id. (citing Borsodi Opening Comments at 23-24).

services, and no service beyond the primary line basic residential service would be capped.[562]

AT&T states that the funding mechanisms and administration of many public policy programs "would be affected by changes in [its] residential basic service rates."[563] Specifically, AT&T notes that California's LifeLine rate is one-half of its current 1Flat Rate (1FR) rate[564] and any change in the price of this service "would affect both the ULTS rate for all consumers and the corresponding subsidy drawn by every carrier across the state."[565] AT&T adds that "fluctuations in carrier draws would require corresponding changes in end-user surcharges."[566]

In contrast to AT&T, Verizon recommends that the Commission cap *all* residential service rates at current levels for three years beginning on the effective date of this decision.[567] At the conclusion of the three-year transition

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[562] Under AT&T's proposal, "[s]econd and additional residential basic service lines beyond the primary line, or primary line residential basic service included in a package or bundle, would be subject to full pricing flexibility." Id. at 63 n. 229 (citing Borsodi Opening Comments at 23. Moreover, even during this transition period, AT&T argues it "should be allowed to lower primary line residential basics services below current levels. . . ." Id. at 63.

[563] Id. at 62.

[564] Id. (citing CPUC General Order 153, Section 7).

[565] Id. (citing CPUC General Order 153, Section 8).

[566] Id. (citing CPUC General Order 153, Section 8).

[567] Verizon Opening Brief at 25.

period, the proposed caps would "*automatically sunset* without the need for further Commission action or litigation."[568]

Verizon suggests the Commission permit full downward flexibility for basic residential (and all other) telephone services.[569] The ILEC argues that "eliminating price floors not only promotes . . . affordability of service, [but] it also advances a fundamental objective of competition itself, *i.e.*, that firms not be discouraged from offering price decreases. Robust price competition is the essence of competition and should be encouraged in any Uniform Regulatory Framework."[570] During the period in which it calls for basic rates to be capped, Verizon adds that the principle of "revenue neutrality" should apply. Under this principle, "price increases to 'basic' services above the cap would require Commission approval, but would be permitted in response to Commission-mandated price decreases to any other price-regulated service, e. g., switched access charges."[571]

Frontier states that "the hallmark of URF should be full upward and downward pricing flexibility for all ILEC services, subject to a limited transition period before the caps on primary line residential service are lifted."[572] The mid-sized ILEC concedes that caps on primary line residential services are warranted

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[568] Id.

[569] Id. at 26.

[570] Id. (citing Aron Opening Comments at ¶¶ 188-191 and Aron Reply Comments at ¶¶ 11, 114).

[571] Id. at 3.

[572] Citizens Opening Brief at 3.

in the near term, due to the complex linkages between basic residential rates and public policy programs, specifically the "funding of the public policy subsidy programs."[573] Frontier, however, requests that the Commission "institute a presumption that the caps be lifted in two years without the necessity of any showing at that time."[574]

SureWest, like Frontier, maintains that "the hallmark of URF should be full upward and downward pricing flexibility for all ILEC services, as this exists for all its competitors in the market. . . ."[575] Nevertheless, SureWest also agrees to a price cap for basic primary residential service rates during a defined transition period of two years. The mid-sized ILEC states that it "is prepared to live with [the cap] for a two year limited transition period starting with the effective date of the decision in this phase. Furthermore, SureWest believes that the presumption should be that the caps are lifted in two years, without any necessary showing at that time."[576] SureWest supports full downward pricing flexibility during this transition period.[577]

DRA opposes lifting price caps for basic residential service and services it deems "associated" with basic residential service.[578] These associated services include "measured local usage, ZUM, and EAS whenever those services are used

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[573] Id. at22.

[574] Id.

[575] SureWest Opening Brief at 4.

[576] Id. at 25.

[577] Id. at 4.

[578] DRA Opening Brief at 5.

in conjunction with a primary line service" and for "residential inside wire maintenance plans."[579] DRA states that the Commission "should not eliminate price caps for essential telecommunications services without clear and convincing evidence that competition is sufficient to constrain the incumbents' market power over the pricing of those services."[580] It then asserts that such evidence of competition is not present: "DRA, TURN, and other parties have presented substantial evidence showing that there is limited competition today for residential and single-line business basic exchange services."[581] DRA holds that the ILECs "failed to demonstrate that competition is ubiquitous throughout their service areas, or that competition is even significant for basic products or services."[582] It also characterizes Verizon's revenue neutrality proposal as "unnecessary."[583]

TURN similarly requests a cap on basic rates and services it deems related.[584] TURN's list of related services include "ZUM, EAS, recurring and non recurring charges"; "Caller ID, call trace, 976 service, 900/976 call blocking, non-published and unlisted telephone numbers, white pages listings and busy line verification and interrupt services"; and "inside wire maintenance plans."[585]

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[579] Id. at 6.

[580] Id. at 17.

[581] Id. at 18.

[582] Id. at 27.

[583] DRA Reply Brief at 19.

[584] TURN Opening Brief at 34.

[585] Id. at 34-35.

TURN contends that "there is no evidence that they [cable telephony, non-cable VoIP and wireless] are currently substitutes for the essential local exchange services that are currently subject to price regulation in California *today*."[586] TURN also urges rejection of Verizon's revenue neutrality proposal.[587]

DOD/FEA recommends that "each Respondent's total revenues from residential and business basic services be constrained by a revenue cap."[588] Specifically, it states that a cap should be placed on the following "basic local services": 1) residential and business primary and additional lines; 2) PBX trunks to the T-1 level; 3) recurring and non-recurring charges; 4) local usage; 5) ZUM and EAS; 6) public telephone; 7) remote call forwarding; 8) telephone assistance; and 9) toll blocking.[589] This proposed revenue cap would remain in place for three years, after which "the Commission can review the marketplace again and determine whether competition is sufficiently robust and ubiquitous to restrain basic local services in the mass market."[590] DOD/FEA claims that currently "local service competition does not provide an effective restraint on prices in the mass market."[591]

While it does not address basic residential service specifically, DisabRA requests that the Commission "organize a task force that would receive input

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[586] Id. at 12.

[587] Id. at 49.

[588] DOD/FEA Opening Brief at 10.

[589] Id. at 11.

[590] Id. at 11.

[591] Id. at 10.

from providers and the disability community, and make recommendations about services to be included for price protection."[592] DisabRA asserts that "the ILECs face little intra- or inter-modal competition in the provision of telecommunications services to Californians with disabilities, and that, as a result, the Commission cannot rely on competitive pressures from the marketplace to ensure that Californians with disabilities will have access to affordable, accessible and reliable telecommunications services."[593]

DisabRA explains that wireline service is particularly important to individuals with disabilities. It observes that "many Californians with disabilities are stuck with wireline service," because "specialized equipment that is required for them to utilize telecommunications services, including equipment provided or subsidized by the state, only works with wireline phones."[594] DisabRA adds that "wireline service provides many Californians with disabilities greater security, and leaves them better prepared for emergency situations, than services such as wireless or VoIP."[595]

CCTA devotes a large portion of its brief to opposing Verizon's proposal for revenue neutrality. CCTA argues that "[t]he principle of revenue neutrality has no place in a uniform regulatory framework because it is a vestige of rate of return regulation that ignores revenues generated from new service."[596]

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[592] DisabRA Opening Brief at 22.

[593] Id. at 12.

[594] Id. at 15.

[595] Id. at 18.

[596] CCTA Opening Brief at 5.

B. Discussion: Market Conditions Support Full Pricing Freedoms for Basic Residential Service Not Subsidized by CHCF-B, but LifeLine Makes Pricing Freedom for Basic Residential Service Inappropriate at this Time

Our analysis of how to address pricing freedoms for basic residential service must review both statutory policies and market conditions. These factors have important implications for pricing flexibility permitted in the future.

The decision of whether to permit pricing freedoms for basic residential service implicates all three statutory policies most relevant to this proceeding: (i) the policy that encourages us to rely upon competition to promote the public interest; (ii) the policy that calls for us to use technologically and competitively neutral measures to encourage a wide variety of new technologies and services; and (iii) the policy that calls for our support of special social goals. These policies are described in detail in Section III.

With respect to the first policy, we find that price controls are incompatible with the emergence of this competition in the voice market. Price controls skew competitors' interests, and they discourage true intermodal competition for voice services, including basic residential service. This Commission, therefore, is compelled to discard price controls in the face of both state and federal policies favoring competition in the telecommunications voice market.

Regarding the second policy, price controls placed only on market participants using one type of technology, but not on other competitors using different technologies, is clearly neither technologically nor competitively neutral. The distorted prices that result from such price controls impact consumer choices, and to the extent that consumer choices do not consider true costs, the policy harms both those offering the service and those that compete with it. This marketplace distortion may discourage a new entrant from joining, or expanding its offerings, in the state's voice market. In turn, Californians may not receive the most advanced communications technologies.

Finally, with respect to the third policy, we find that pricing policies for basic residential service are closely linked to our state's LifeLine program as well as CHCF-B, which we addressed in the prior section. The Public Utilities Code requires that LifeLine service shall "not be more than 50 percent of the rates for basic flat rate service."[597] A change in ILECs' basic residential service rates has a direct impact on the amount of money available to support the LifeLine program. This statutory requirement means that any changes to basic residential rates directly impact the funding needed to support LifeLine, which is a critical universal service program designed to bring local phone service at affordable rates to low income Californians. An in-depth examination of the relationship between the basic residential rate level and the amount of funding needed to support LifeLine is scheduled to occur in our Universal Service, Public Policy Programs rulemaking, R.06-05-028. This Commission recognizes that any changes to basic residential rates should be consistent with the LifeLine policies that will be addressed in the universal service proceeding, which was initiated on May 26, 2006. It is important that this issue be looked at in tandem with the important LifeLine policies and programs; premature action on the basic residential rates absent such a review would be unwise.

In addition to statutory policies, market conditions also guide our analysis of pricing freedoms for basic residential rates. A key question is whether competition is sufficient to ensure that telecommunications rates remain

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[597] CAL. PUB. UTIL. CODE § 871.5(a).

reasonable. In Section V, we addressed this question and concluded that the combination of FCC-mandated unbundling policies, the required provision of stand-alone DSL service by Verizon and AT&T, and substantial cross-platform competition obviate the need for continuing price controls on services not subsidized by CHCF-B. We, therefore, hold that market conditions support pricing freedoms for basic residential rates that are not subsidized by CHCF-B.

This policy position is consistent with that of many other states who have led the way in deregulation of telecommunications markets. Verizon points out that a number of states have already made similar reforms to regulation of basic residential rates:

> Alaska, Idaho, Iowa, Oklahoma, and Texas have all adopted new regulatory plans that remove any continuing price caps on basic services on dates certain from 2007 to 2010, consistent with Verizon and the other incumbents' proposals. Rhode Island removed residential price caps altogether with no automatic review of the plan, though parties can petition for a review in three years, if necessary. And Indiana just passed a law that permits yearly price increases to basic services through June 30, 2009, at which time all retail prices, including prices for basic services, will be deregulated.[598]

The removal of price caps on basic telecommunications services is a policy that many forward-looking states are adopting either immediately or with dates certain as they seek to revise telecommunications policies consistent with national trends.

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598 Verizon Reply Brief at 11 (citations omitted).

We choose to lift price caps for unsubsidized basic residential rates on a date certain. Specifically, we order the removal of price caps on basic residential services that are not subsidized by CHCF-B as of as of two years from the issuance date of this decision. This delay in allowing this pricing freedom to go into effect will give the Commission sufficient time to rethink the relationship between CHCF-B and basic residential rates in R.06-05-028, our Universal Service Public Policy Programs proceeding. After two years has passed, the cap on basic residential service rates will no longer serve the public interest, and accordingly, the cap will sunset automatically with no further PUC action required.

Additionally we will adopt the principle of revenue neutrality in this transition phase. While we agree with CCTA that this principle has no place in a uniform regulatory framework that supports a competitive marketplace, the ILECs may apply the revenue neutrality principle during the transition period in order to offset Commission-ordered price decreases in other regulated services with revenue neutral price increases in basic services. We emphasize that application of the revenue neutrality measure will end when we lift the basic residential rate price cap in two years.

We find it necessary, however, to continue to place price floors on basic residential rates. While we acknowledge arguments that eliminating price floors promotes affordability, we believe a price floor remains necessary due to the statutorily imposed link between the LifeLine rate and the basic residential rate.[599] This price floor on basic residential rates is necessary to ensure that we are able to support the LifeLine program in accordance with statutory objectives.

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[599] CAL. PUB. UTIL. CODE § 871.5(a).

Since the law caps LifeLine rates at one-half of the 1Flat Rate (1FR) basic residential rate, any decrease in the price of the basic residential rate would change both the LifeLine rate for all consumers and the corresponding subsidy drawn by every carrier in the state under that LifeLine program. Resulting fluctuations in carrier draws in the LifeLine program would require corresponding changes in end-user surcharges. Thus, we hold that we will not allow basic residential rates to fall below AT&T's current 1 Measured Rate (1MR) and 1FR rates, unless the Commission in R.06-05-028 adopts some other policy consistent with the LifeLine statutory scheme.

DisabRA has raised valid issues relating to telecommunications services and the disability community. Nevertheless we find that these issues are best left to R.06-05-028, in which we will review programs that ensure members of the disability community receive telecommunications services. In addition to examining LifeLine, R.06-05-028 also will review the deaf and disabled telecommunications program. Input will be gathered from the disability community via public hearings in the proceeding. R.06-05-028, consequently, is the appropriate proceeding for determining how to revise our policies in light of increasing levels of competition. Price changes that we make today leave in place programs of special interest to the disabled communities in California.

Furthermore, as our discussion of statutes and market conditions makes clear, neither statutes nor market conditions make it necessary to continue price regulation for any of the services "associated" with basic service. In particular, we see no reason to continue price regulation of measured local usage; ZUM; EAS; recurring and non-recurring charges; Caller ID; call trace; 976 service; 900/976 call blocking; non-published and unlisted telephone numbers; white pages listings; busy line verification and interrupt services; or inside wire maintenance plans.

Finally, we will remain vigilant in monitoring the telecommunications marketplace. We will ensure that basic residential service remains affordable and does not trend above the current highest basic residential rate in the state, no matter the technology employed to offer such service. Should we see evidence of market power abuses, we retain the authority and firm resolve to reopen this proceeding to investigate such developments promptly.

VIII. Single-Line Basic Business Rates

Although there is only one market for voice communications services in California, the record concerning basic business services was developed in great detail. We, therefore, focus on pricing policies for basic business service in this section so that we can address parties' specific arguments and supporting evidence at greater length.

A. Position of Parties

AT&T proposes that the Commission authorize the ILECs to exercise full pricing flexibility for single-line business basic services (1MB).[600] SureWest and Frontier also support this proposal.[601]

AT&T maintains that there is no justification for a price cap on single-line business basic service. AT&T notes that there are a number of competitive alternatives for business customers, and there is robust competition in that

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[600] SBC California Opening Brief at.58-59.

[601] Frontier RB at 18; SureWest RB at 21-22 Frontier RB at 18; SureWest RB at 21-22

market.[602] The ILEC notes that basic business service rates are not subsidized by public policy programs, like residential basic rates are for universal service reasons.[603] .

AT&T asserts that artificially regulating the price of a service that can (and should be) set by the competitive process harms customers.[604] AT&T argues that regulation can restrain the ability of telecommunications carriers to respond to competition.[605] In contrast, prices move toward cost and the full benefits of competition flow to customers when the competitive process is allowed to function without regulatory distortions.[606]

Verizon proposes to cap single-line business basic services (1B)[607] prices and associated non-recurring costs (NRCs) at their current levels for three years beginning on the effective date of this decision.[608] Verizon contends that this three-year transition period to full pricing flexibility would provide the Commission with "additional assurances that the new framework will achieve its intended result."[609] Verizon adds that the transition period would give the

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602 SBC California Reply Brief at 25, citing Dr. Taylor, Exhibits 28, 29.

603 SBC California Opening Brief at 82.

604 SBC California Opening Brief at 63.

605 SBC California Opening Brief at 63.

606 *Id.* at 25-26.

607 Verizon's 1B is equivalent to other NRF ILECs' 1 MB; both are referring to single-line business basic services.

608 Verizon OB at 24-26.

609 Verizon OB at 24.

Commission time to address other important public policy initiatives beyond the scope of this OIR, such as reforming the universal service subsidy programs.[610] At the conclusion of this three-year transition period, the caps would *automatically sunset* without the need for further Commission action or litigation.[611]

DRA urges the Commission to cap the 1MB price at current levels and to retain related monitoring.[612] It also recommends that the Commission review 1 MB in three years.[613] DRA explains this review is necessary for determining whether the service should be fully price de-regulated, because currently the record supports retention of price caps "for basic single-line business services *and the usage* associated with those services."[614] DRA states that regulating the price of access lines without regulating the price of associated usage will enable the incumbents to avoid any meaningful price constraints on basic exchange services.[615]

TURN supports granting downward pricing flexibility subject to its price floor constraints, but TURN, like DRA, proposes that 1 MB be subject to a three-year price cap.[616] TURN argues that there is little or no competition for local

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[610] Verizon OB at 24-25.

[611] *Id*.

[612] Comparison URF Proposal

[613] Comparison URF Proposal

[614] DRA OB at 6.

[615] DRA OB at 6.

[616] TURN OB at 34.

exchange service that, for the purpose of this proceeding, encompasses residential and business primary lines; local usage; ZUM; EAS; recurring and non recurring charges; and additional lines for business and PBX trunks. Thus, TURN concludes that the Commission should not grant complete pricing flexibility for these services at this time and should instead re-examine this issue in three years through another proceeding.[617]

DOD/FEA agrees with Verizon, Cox, CSBR/CSBA, and DRA in urging the Commission to continue limited price protection for small businesses.[618] DOD/FEA, however, recommends a revenue cap instead of a price cap. Under this proposed revenue cap, each respondent's total revenues from residential and business basic local services would be capped at a certain revenue level.[619] DOD/FEA further suggests that these revenue caps remain in effect for three years, "at which point the Commission would review their effectiveness as well as the existing state of competition in California."[620]

Given the demise of UNE-P availability, DOD/FEA observes that small business customers may not benefit from competition as much as residential customers. DOD/FEA notes that while competitors may offer local service telephony to mass market customers as part of an attractive package including television and/or high-speed Internet access, small businesses, which usually do not need either television or high-speed Internet access, are less likely to find

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617 *Id.*

618 DOD/FEA OB at 10-11.

619 DOD/FEA OB at 10.

620 *Id.*

cable service packages attractive.[621] DOD/FEA consequently urges the Commission to follow the path of most of the other states, which have gone through deregulation, and retain price regulation for basic business services at least for the next few years.[622]

CSBRT/CSBA recommends that the Commission continue to regulate basic business rates for at least the near future and does not propose any changes in rates or current regulatory procedures. CSBRT/CSBA contends that the current level of competition is unable to check ILECs' market power over basic business rates. Citing the FCC's latest *Local Competition Report*, CSBRT/CSBA indicates that there are fourteen zip codes in California where there are no CLECs and another thirty-two zip codes where there are only one to three LECs.[623] CSBRT/CSBA also points out that the FCC's latest *Wireless Competition Report* indicates that the penetration rate for wireless service in less densely populated areas is twenty percent below major metropolitan areas, and there are some rural areas with few, if any, wireless service providers.[624]

Furthermore, CSBRT/CSBA maintains that regulating basic business rates in the near term will give the Commission time to attain better information about the deployment of competitive services.[625] CSBRT/CSBA urges this Commission to support the FCC as it prepares its Section 706 report on the provision of new

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621 *Id.*

622 *Id.*

623 CSBRT/CSBA Opening Comments at 7.

624 CSBRT/CSBA Opening Comments at 7.

625 *Id.* at 8.

technologies and services,[626] and notes that in the near future the FCC may clarify some issues related to VoIP service.[627]

Time Warner advocates that the Commission set price caps for basic business service at current rates and allow inflation adjustments annually thereafter.[628] Time Warner also urges adoption of a policy in which the price would be above a cost-based price floor.[629] Cox and CCTA generally support Time Warner's proposal.[630]

Time Warner states that the record indicates that AT&T and Verizon continue to dominate the business market. It points out that DOD/FEA shows that the ILECs, together, control seventy-three percent of the medium/large business/institutional market and eighty-six percent of the residential and small business market in California. Time Warner adds that DRA's confidential data confirms the ILECs' market dominance.[631] Time Warner asserts that these large ILEC market shares, which have persisted after "12 years of competition . . . are a

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[626] *Id*. at 8.

[627] These issues include E-911, universal service support, and bundling of broadband and voice services.

[628] Comparison URF Proposals

[629] Time Warner OB at 7. The price floors proposal of Time Warner is addressed in detail in Section XI, below.

[630] Comparison of URF Proposals.

[631] Time Warner RB at 2-3.

testament to why there cannot be flash-cut symmetric regulation of ILECs with their smaller competitors in the business market."[632]

B. Discussion: Full Pricing Flexibility for Basic Business Service Is Reasonable

State and federal statutes are relevant to this analysis in two central ways. First, the statutes encourage reliance on open and competitive telecommunications markets. Second, the statutes instruct regulators to use technologically and competitively neutral measures to encourage further development of new technologies. Neither of these statutory policies limits our ability to allow pricing freedoms for basic business rates; indeed, these policies support greater pricing freedoms.

We, therefore, next consider whether market conditions will place sufficient checks on ILECs' power over pricing basic business rates. This analysis is not as restricted as CSBRT/CSBA suggests it should be. While there are fourteen Zip codes in California that lack a CLEC, this statistic alone does not indicate that ILECs continue to have market power in those fourteen Zip codes. We also must consider the *potential* for CLEC competition and the entry of VoIP and wireless into the voice market.

We turn back to our analysis in Section V. First, we saw that unbundling requirements continue to apply throughout the service territories of SureWest, Verizon, AT&T, and Frontier, and the threat of market entry by a CLEC checks market power throughout entire ILEC service territories.[633] Second, we cited

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[632] Time-Warner RB at 2.

[633] See Section V, subsection D above.

evidence that shows that broadband is available in one hundred percent of all California ZIP codes.[634] This widespread availability of broadband makes it possible for any business with access to broadband to purchase VoIP services, either directly from the broadband provider or from a "pure play" VoIP provider, like Vonage.

Moreover, wireless competition plays a particularly role in the basic business segment of the telecommunications marketplace. AT&T notes that "78 percent of small business owners use mobile wireless service and over three fourths of these consider mobile wireless service to be essential or important to their business operations."[635] AT&T also states that "25 percent of small businesses spend more on wireless than on local and long distance combined."[636] These statistics convince us that there already is significant cross-platform competition among providers of basic business service.

In conclusion, there is no evidence concerning the basic business segment of the telecommunications market that causes us to reassess the conclusions reached in our general market analysis. Indeed, the evidence that we have supports our two major conclusions – that there is a single market for voice communications and this market is subject to significant competition by different technologies. Consequently, we find that it is reasonable to eliminate all price regulations of basic business service effective immediately.

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[634] Verizon Reply Brief, p. 23.

[635] AT&T, Reply Brief, p. 29.

[636] AT&T, Reply Brief, p. 29.

IX. Forbearance from Regulating the Pricing of New Telecommunications Services

Any ILEC or CLEC that wants to introduce a new service in the state first must seek Commission approval through an advice letter process. All ILECs currently are required to file an advice letter thirty days before introducing new products, services, or technologies. An ILEC's advice letter must be accompanied by supporting cost data.[637] CLECs also have to file an advice letter for new services, and such advice letters have the same thirty-day effective date. Unlike ILECs, however, the CLECs do not have to provide supporting cost data.

For both ILEC and CLEC advice letters, third parties may protest such advice letters. Protest of an advice letter may delay its approval for anywhere from approximately three months to multiple years, depending on how long it takes the Commission to resolve the matter.

In contrast, other competitors to ILECs and CLECs do not have to make any regulatory filings when offering new or any other services. VoIP providers are not regulated by this Commission, and for wireless carriers, the Commission regulates only "terms and conditions," not prices or offerings. We address this disparate regulatory treatment below.

A. Position of Parties

All four ILECs, DOD/FEA, and CSBRT/CSBA propose that we allow full pricing flexibility for new telecommunications services and we limit our review

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[637] If a smaller ILEC mirrors the rates and/or charges of the larger ILECs, however, it is not required to file a cost study.

of these services to a one-day advice letter filing.[638] These parties advocate for full pricing flexibility based on competitive parity, and contend that under their proposal, benefits will flow to consumers. AT&T argues that preparing regulatory cost data and meeting the thirty-day approval requirements for new services hinder competition.[639] According to Verizon, as long as any competitor is constrained in its ability to respond quickly to consumer demand, to offer new services and new bundles, to innovate, to provide leading edge technologies, to respond to competitors' market moves, and to realize the full risks and rewards of its actions, competition as a whole suffers and so do consumers.[640]

Like most parties commenting on this issue, DRA urges the Commission to forbear from imposing price regulation on new services, and recommends that we allow the ILECs to establish prices for those services effective on a one-day advice letter filing.[641] DRA, however, urges the Commission to retain the right to suspend an incumbent's new service offerings thereafter for good cause shown, such as if that incumbent was attempting to deregulate a price-regulated service by disguising that service as a "new" service.[642]

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638 Comparison of URF Proposals; Verizon Opening Brief at 3; Pacific Bell Opening Brief at. 61; SureWest Reply Brief at. 18-19; Citizens Reply Brief at 15; DOD/FEA Reply Brief at 5-6.

639 Pacific Bell Opening Brief at 61.

640 Verizon Opening Brief at 1.

641 DRA Opening Brief at 5.

642 ORA Reply Comments at 11.

The CLECs, Cox, CCTA, and Time Warner support flexibly-priced new services, if the services truly are new ones.[643] According to Cox, new services must be strictly defined to preclude the repackaging of existing services or bundles just to avoid regulations that may apply to "basic" services.[644] Cox asserts that the delivery of a "basic" service from an ILEC using new technology (e.g., VoIP) should not qualify as a new service, because the customer is receiving basic voice service whether it is provided over copper or cable, circuit-switched or packet-switched. Cox adds that the FCC used such service-based criteria to determine the appropriate classification and application of regulation in two rulings issued on regulation of VoIP services.[645]

TURN and DisabRA argue that new services should continue to be price-regulated on a case-by-case basis.[646] TURN supports the current process, i.e., Commission notification of new services through the thirty-day advice letter process. Similar to the CLECs, TURN does not regard an existing service, provided using a new technology, to be a new service.[647] It points out that the Commission has not permitted voice services to be reclassified as new services

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[643] Comparison of URF Proposals; Cox Opening Comments at 19.

[644] Cox Opening Brief at 19.

[645] Cox Opening Comments at 19 (citing In the Matter of Petition for Declaratory Ruling that pulver.com's Free World Dialup is Neither Telecommunications or a Telecommunications Service, W C Docket No. 03-45, Memorandum Opinion and Order (released Feb. 19, 2004); In the Matter of Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, WC Docket No. 03-211, Memorandum Opinion and Order (released Nov. 12, 2004)).

[646] Comparison of URF Proposals.

[647] TURN Reply Comments at 13.

when carriers have upgraded their feeder plant to fiber-based Next Generation Digital Line Carrier systems.[648]

B. Discussion: Neither Policy nor Market Conditions Support Limiting the Rates of New Telecommunications Services

The prior overview of statutory goals makes it clear that the California Legislature calls upon us to support deployment of advanced telecommunication services and infrastructure through pro-competitive policies.[649] Requiring burdensome and time-consuming regulatory reviews before approving the introduction of new telecommunications services is inconsistent with this competition-driven policy. Moreover, since the ILECs face more burdensome reviews than other carriers, the current policy is not technologically and competitively neutral, as required by statute. These policies unfairly place ILECs at a disadvantage in the telecommunications market. We previously held this market was sufficiently competitive to check ILECs' market power.

Although the parties to this proceeding have all advanced proposals that are considerable improvements over the status quo, we prefer the proposal to permit the provision of new services with full pricing flexibility on a one-day advice letter filing. This approach is most consistent with the statutory framework and current market conditions. In particular, the proposal creates no regulatory obstacles or regulatory uncertainties that could significantly delay introduction of new services.

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648 Roycroft Reply Comments at 95.

649 See CAL. PUB. UTIL. CODE §§ 882, 8281(a), 709.5(a).

Several parties propose limitations of various sorts on the introduction of new services. For example, DRA asks that the Commission retain the right to suspend an incumbent's new service offerings thereafter for good cause shown. Such a restriction would likely have two effects: (1) it would introduce additional regulatory uncertainty for only one player in the market, the ILEC; and (2) it would deter price changes (including price decreases) when services resemble other telecommunications services. We further note that the continued availability of the "old" services protects consumers from higher priced "new" services. Thus, this proposed limitation serves no public purpose, and is quite likely to have an anti-competitive effect.

The proposals of the Cox, CCTA, Time Warner, TURN and DisabRA are also restrictive. The proposed limitations would be anticompetitive and would discourage and delay the introduction of new services to consumers. Hence, we also find that these restrictions are not in the public interest. In summary, we find that it is in the public interest that all carriers should be able to offer new services on a one-day tariff filing without supplying cost-support data.

X. Tariffing of Services and Contracts; Price Floors; and Price Ceilings

To ensure that the prices charged for telecommunications services are "just and reasonable,"[650] the Commission has developed over the years a large body of rules for both the tariffing of services and the establishment of price floors and price ceilings, which may include the review of contracts and the publication of contract terms. We now turn to such regulatory policies that apply to changes in

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650 CAL. PUB. UTIL. CODE § 451.

the pricing of residential and business retail telecommunication services currently available in California. These services generally are available through tariffs or contracts, which are also known as individual case bases tariffs.

A. Positions of Parties

AT&T proposes "full pricing flexibility for all residential and business services."[651] AT&T states that this proposal "means eliminating all pricing restrictions and limitations, including service categories, price floors (including imputation rules), price ceilings, requirements to provide cost data, and any other limitations on pricing."[652] For all services excluding basic residential services, "[a]dvice letter filings for tariff changes [w]ould be effective one day after the filing."[653]

AT&T's justification for this pricing policy reform flows from its market analysis. AT&T argues that "[e]liminating burdensome filing and cost requirements is not only consistent with a market-oriented approach to regulation, it will further regulatory symmetry among telecommunications market competitors."[654] In particular, for price floors, AT&T asserts that "explicit price floors may have made sense in an environment where competition was limited and service components provided by ILECs were actually required for

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651 Pacific Bell Opening Brief at 58.

652 Id. (footnotes omitted).

653 Id. at 59.

654 Id. at 58.

competitors to enter the market. That environment, however, does not exist today."[655]

Likewise, AT&T maintains its proposal for contracts would "further the Commission's goal of treating all telecommunications competitors in a neutral manner and accelerate the delivery of contract benefits to customers."[656] Specific reforms proposed are as follows:

> [T]he Commission should eliminate pricing restrictions for contracts and associated cost data requirements. The Commission should also streamline the filing process for contracts by allowing them to become effective upon execution by the parties, with the contract to be filed at the Commission within 15 days.[657]

AT&T argues that without these reforms the Commission will continue to restrict its ability to "meet[] the needs of customers through contracts."[658] AT&T explains that it "is required to prepare and file supporting cost data with its contracts, and customers must wait as long as 40 days (assuming no protests are filed) for the contract to take effect."[659]

Verizon similarly supports pricing reforms. Concerning tariffing, Verizon makes the following proposal:

> Full pricing flexibility would be immediately accorded for all non-"basic" intrastate retail services, including usage; Key, PBX, multi-

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[655] Id. at 82.

[656] Id. at 59-60 (citations omitted).

[657] Id. (citations omitted).

[658] Id. at 56.

[659] Id. at 56-57 (citation omitted).

> line, and additional residential lines; ZUM; and inside wire maintenance. Price increases would be effective on 25-day prior customer notice and Advice Letter ("AL") filing. Price decreases would be effective on 1-day AL filing.[660]

In addition, Verizon urges elimination of price floors for all intrastate, retail services.[661] The ILEC argues that this elimination of price floors would not only promote "the OIR's goal of affordability of service," but it also would advance "a fundamental objective of competition itself, i.e., that firms not be discouraged from offering price decreases."[662] Furthermore, given the level of intermodal competition, Verizon argues that, "even if price floors were necessary . . . it would not be practical for the Commission to determine what an appropriate price floor would be."[663] It explains that there is no consistent cost basis among intermodal carriers to determine an appropriate floor, since intermodal competitors do not use incumbent wireline networks to provide service.[664] Finally, regarding contracts, Verizon proposes that Individual Case Basis (ICB) contracts be made effective on their own terms and be filed with the Commission within thirty days of execution.[665] No cost support would be required.[666]

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[660] Verizon Opening Brief at 3.

[661] Id.

[662] Id. at 26.

[663] Id. at 28 (citation omitted).

[664] Id. at 28 (citation omitted).

[665] Id. at 3.

[666] Id.

SureWest and Frontier support a streamlined advice letter process in which tariffs would go into effect in one day, but any tariff that increases prices would require a twenty-five-day notice to customers.[667] The mid-size ILECs also recommend the elimination of all price floors.[668] SureWest argues that price floors prevent customers "from receiving the full benefits that downward pricing flexibility might provide."[669]

Concerning contracts, SureWest and Frontier see no merit to requiring the filing of contracts with the Commission.[670] SureWest argues that their "contracts should be treated like other commercial contracts in any market. They are legally binding and enforceable in the courts, but of no regulatory importance unless they violate other laws."[671] SureWest reasons that if "ILECS are not required to submit cost support for contracts . . . the requirement to file contracts will lose much significance."[672] Continued imposition of this requirement, according to SureWest, "wastes carrier and Commission resources with little of no countervailing benefit."[673]

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667 SureWest Opening Brief at 30; Citizens Opening Brief at 26.

668 SureWest Opening Brief at 20; Citizens Opening Brief at 17.

669 SureWest Opening Brief at 20.

670 SureWest Opening Brief at 30; Citizens Opening Brief at 26.

671 SureWest Opening Brief at 30.

672 Id.

673 Id.

DRA submits a more complex proposal. It suggests reforming regulation of tarrifed services in the following manner:

> [P]rice increases (where permitted) would be effective on 30-day advice letter filing and 25-day prior customer notice. Price decreases would be effective on 1-day advice letter filing. Contracts would become effective based on their own terms and conditions; the incumbents would be required to file contracts with the Commission within 15 days of their execution. Any required advice letter filings could be protested only for improper noticing or filing procedures, and no cost support would be required.[674]

DRA further urges elimination of Commission-established price floors for telecommunications services, a measure that would enable unlimited downward flexibility for all services.[675] If competitors in the future have a complaint about ILECs' retail pricing, DRA states that they would go "directly to the courts and be allowed to make their case free from any pretense that the Commission has pre-determined economically meaningful price floors."[676]

DRA nevertheless states that some price regulation should continue to apply to certain services:

> [P]rice caps should apply to both recurring and non-recurring charges. Price caps also would apply to measured local usage, ZUM, and EAS whenever those services are used in conjunction with a primary line service, but not otherwise. Finally, to avoid *de facto* price increases for residential primary line services, DRA

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674 DRA Opening Brief at 7.

675 Id.

676 Id.

> proposes to retain the current price caps for residential inside wire maintenance plans.
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> The record concerning competition for business services supports retention of price caps for basic single-line business services *and the usage* associated with those services. Regulating the price of access lines without regulating the price of associated usage would enable the incumbents to avoid any meaningful price constraints on basic exchange services. DRA also recommends retaining price caps for PBX trunks, an essential input for the use of PBX systems as an alternative to the incumbents' Centrex/CentraNet offerings.
>
> Finally, given the ILECs' dominance over basic access lines, DRA also recommends retaining price caps for special access (which the OIR indicated would be addressed in Phase 2 of this proceeding) and for E911 services.[677]

DRA explains that price caps will ensure services will remain affordable.[678]

TURN proposes that the Commission adopt a price cap that would apply to "residential and business primary lines, local usage, ZUM, EAS, recurring and non recurring charges, and additional lines for business and PBX trunks"[679] as well as "Caller ID, call trace, 976 service, 900/976 call blocking, non-published and unlisted telephone numbers, white pages listings and busy line verification and interrupt services."[680] This recommendation is consistent with its analysis that ILECs retain substantial market power.

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[677] Id. at 6.

[678] Id.

[679] TURN Opening Brief at 34.

[680] Id. at 34-35.

TURN also supports a number of other price controls. It would impose controls on "services which are essential for persons with disabilities"[681] and "inside wire maintenance."[682] TURN adds that we should continue price floors. Under TURN's proposal the Commission should require "all carriers to price services higher than the lesser of long run incremental costs or the tariffed price on the date that the market is deregulated,"[683] but only as long as these regulations are "combined with a monitoring program and the three year review."[684]

TURN recommends establishing uniform rules for tariffing and contracting by extending regulation to all competitors. With respect to tariffing specifically, TURN would establish uniform rules by extending regulation to all competitors. TURN supports "an advice letter process with a 1-day filing requirement for a price decrease, a 30-day filing requirement for a price increase, and a 25-day customer notice for a price increase."[685] For contracting, TURN states that "contracts should become effective on their own terms, with a 15 day filing requirement. Given the concerns expressed above with respect to price floors and bundles/packages, on a transitional basis (until sufficient competition develops) tariffed service rates should be imputed in contracts."[686]

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681 Id. at 35.

682 Id.

683 Id.

684 Id.

685 Id. at 38.

686 Id. at 39.

Similarly, DisabRA would continue price controls on a wide group of essential services.[687] It too contends that there is little competition in the telecommunications marketplace.[688]

DOD/FEA provides broad support for flexible tariffing and simple contracting procedures. It states that "[p]rice decreases should be implemented on 1-day notice and price increases on 30-day notice without burdensome and unnecessary cost support."[689] With respect to contracts, DOD/FEA contends that ICB "contracts should be effective upon execution by the parties. Cost support should not be required, but the contracts should be filed with the Commission within 15 days of execution."[690]

Cox argues that non-basic services should have no price regulation and that tariffing and customer procedures should be "standardized at the current requirements of competitors."[691] Regarding contracts, Cox states that "contracts should be effective on execution and that the Commission should not require that they be filed."[692]

Time Warner focuses on price floor issues. It asks that the Commission establish a price floor using "either the prices already adopted for wholesale inputs or UNEs or the current tariffed prices and then simply use the latest 'Total

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[687] DisabRA Opening Brief at 22-23.

[688] Id. at 11-12.

[689] DOD/FEA Opening Brief at 8.

[690] Id. at 9.

[691] Cox Opening Brief at 24.

[692] Id.

of the Floors' imputation approach adopted in D.04-11-022."[693] Time Warner argues that "[u]nder this approach, any regulated offering of telephone service must be sold above its long run incremental cost . . . and requires that the ILECs' prices be equal to or greater than the wholesale prices charged competitors."[694] Time Warner asserts that this approach is needed to protect against potential anticompetitive actions by ILECs.

B. Discussion: Statutes and Market Conditions Support Streamlined Tariffing and Contracting Procedures

We find two of the statutory policies we reviewed in Section III to be particularly relevant to this section. First, California statutes direct us to use technologically and competitively neutral policies to encourage wide choice in telecommunications services. Second, statutes instruct us to support competition in the telecommunications marketplace whenever possible. Both of these statutory policies conflict with our current tariffing and contracting regime.

Furthermore, our previous discussion of the state of telecommunications market in California established that the pricing power of ILECs is sufficiently checked by a number of competitive forces. These forces include the realistic threat of entry carriers in any market using UNE-L and the widespread competition offered by wireless, cable, and VoIP providers. These market conditions lead us to conclude that we should rely on market forces – rather than time consuming and burdensome regulatory proceedings concerning tariffing and contracting – to promote the public interest. Continued tariffing and

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693 Time Warner Opening Brief at 7.

694 Id.

contracting procedures may even disadvantage consumers by unnecessarily driving up costs and delaying price decreases.

In a fast-moving technology space like telecommunications, there is no public interest in maintaining an outmoded tariffing procedure that requires the regulatory review of cost data and delays the provision of services to customers. This system only made sense in a world where there was a single dominant ILEC, and active regulatory intervention was required. Thus, it is reasonable that all advice letters for tariffed services should go into effect on a one-day filing, but any tariffs that impose price increases or service changes require a twenty-five-day advance notice to all affected customers. Customers should have some notice of price increases in order to decide whether to keep the service or switch to a competitor.

We, however, do not find that we need to maintain general price floors and the submission of cost data. Time Warner, a carrier that obtains critical wholesale services from ILECs, argues that price floors will protect against anticompetitive actions, such a price squeeze in which an ILEC charges itself less for a wholesale input that it charges a competitor. Yet such a pricing policy is already illegal. Moreover, the price floor proposal recommended by Time Warner is cumbersome and more difficult to implement than it acknowledges. Establishing a price floor at the "total of the floors" is no simple matter, particularly since there are services for which no Long-Run Incremental Cost will be available.

If an ILEC engages in illegal pricing behavior, the existence of UNE-L prices should, for any ILEC service using a loop, simplify the identification and determination of a "price squeeze": Those services provided on one loop should have a price above UNE-L for that loop. So rather than adopt a "price floor" that would require us to institute a regulatory review program, we instead caution ILECs that any bundle of telecommunications service using a local loop that is priced below UNE-L is creating a de facto price squeeze. We invite any company harmed by such an action to file a complaint with this Commission.

Concerning contracting, telecommunications markets are ready to adopt the practices commonly used in competitive markets. Contracts will be effective upon execution. We will, however, require that contracts be filed with the Commission within fifteen days after execution. This filing requirement will enable the Commission and interested parties to ensure that telecommunications carriers do not violate the anti-discrimination requirements embedded in state law.[695]

XI. Bundling and Promotional Constraints

The current policies regulating the bundling of telecommunications services require that the price of the bundle of services pass a test to ensure that the prices exceed costs.[696] Currently, pursuant to D.04-11-022, AT&T and Verizon can bundle or "package" Category II services "so long as the revenue from all the services over the expected location life is equal to or exceeds the total of the recurring and nonrecurring price floors for each service."[697] This decision "only applies to NRF-regulated ILECs with: (a) approved wholesale rates for

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695 See CAL. PUB. UTIL. CODE § 558.

696 Bundles are simply a way of combining a group of voice services together to meet the needs of customers.

697 Application of Pacific Bell Telephone Company dba SBC California to Modify D.94-09-065 to Enable SBC California to Reduce Prices to Meet Competition, D. 04-11-022, 23, mimeo at 23, 2004 Cal. PUC LEXIS 530.

basic exchange service or (b) wholesale rates for basic exchange service filed with the Commission, pending approval."[698] Since SureWest and Frontier do not have UNE rates on file with the Commission, they cannot bundle at present. There are no rules regulating bundles offered by the CLECs.

Concerning promotions, current policy requires all local exchange carriers (both ILECs[699] and CLECs[700]) to obtain Commission approval for promotions.[701]. The specific rule for CLECs is that promotions should last no more than one year; if a CLEC promotion lasts more than a year, it shall be considered a permanent offer and subject to withdrawal on thirty-day notice. Current policy restricts promotions by ILECs to 240 days (a 120-day initial period and a 120-day extension). Also an ILEC must wait 60 days after a promotion has run for 240 consecutive days before it can offer the same promotion. There is no prohibition on promotions based on the geographic location of the customer. Under § 251(c)(4)(B) of the Telecommunications Act of 1996, however, promotions lasting longer than ninety days must be subject to resale. This provision restricts ILECs' ability to circumvent their resale obligations under the Act simply by offering services to their customers at perpetual "promotional" rates.[702]

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698 Id.at 23-24.

699 See Tariff (T) -15613.

700 See T-14518.

701 Promotions are methods of bringing a product to public attention, including advertising, publicity, and other sales tactics.

702 See Iowa Utilities Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), aff'd in part, rev'd in part sub. nom. AT&T Corp. v. Iowa Utilities Bd., 525 U.S. 366 (1999) (describing the rationale for Section 251(c)(4)(B)).

A. Positions of Parties on Bundling

The majority of communications services sold are in bundles, rather than on a stand-alone basis,[703] so policy decisions affecting bundles are especially significant for California consumers. The positions of parties on bundled services span the spectrum from urging flexible pricing without limitations, to flexible pricing with increasing restrictions.

The ILECs, DOD/FEA, and CSBRT/CSBA concur that bundles should be flexibly priced with no limitations.[704] DOD/FEA reasons that pricing restrictions on bundles should be eliminated to allow for the same flexibility afforded competitors.[705]

While DRA supports flexibly-priced bundles[706], it also recommends that the Commission direct that there be full disclosures to customers about their ability to purchase individual price-regulated services at regulated prices instead of bundles. DRA further supports a one-day filing for price changes for bundles

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703 Pacific Bell Reply Brief at 24.

704 Comparison of URF Proposals; Pacific Bell Reply Comments at 24; Verizon Reply Brief at 11; Citizens Reply Brief at 15; SureWest Reply Brief at 18; DOD/FEA Reply Brief at 5-6; CSBR/CSBA Opening Comments at 6-7.

705 DOD/FEA Reply Brief at 5-6.

706 Specifically, it proposes that price caps be lifted for any bundle of services that includes at least one non-priced-regulated service. Therefore, service bundles made up solely of basic, essential services would continue to be price capped. DRA Opening Brief at 5, n.11.

and a protest period.[707] DRA contends that its proposal would provide as much pricing freedom for bundles as Verizon's proposal.[708]

Cox, CCTA, and Time Warner recommend a number of different pricing limitations for ILEC bundles. While they support flexibly-priced bundles if the bundles do not include basic service,[709] Cox and CCTA propose that the basic service price be imputed for bundles including basic service.[710] Time Warner recommends limiting the price of all bundled services to an amount equal to or above the sum of the previously set wholesale price or tariffed rate of the regulated service(s) or product(s).[711]

Both CCTA and Time Warner also state that any elimination of existing pricing requirements for bundles should be made contingent upon prior reform of CHCF-B and elimination of the presumption of revenue neutrality.[712] Cox asks for the elimination of high-cost subsidies before we grant full pricing-flexibility for basic residential service (stand-alone or bundled).[713] Cox argues that the ILECs "intend to use the high-cost subsidies to fund their targeted price

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[707] Comparison of URF Proposals; ORA Reply Comments at 11.

[708] DRA Reply Brief at 6.

[709] Comparison of URF Proposals.

[710] Comparison of URF Proposals; Cox Opening Comments at 14.

[711] Comparison of URF Proposals; Time Warner Reply Brief at 4.

[712] Comparison of URF Proposals; Time Warner Reply Brief at 4-5.

[713] Cox Reply Brief at 6.

reductions, offering lower prices on subsidized services where they face the most inroads from competitive entrants."[714]

TURN recommends that price increases for bundles be based on a price cap mechanism and that price decreases be limited to price floors.[715] DisabRA agrees with this proposal.[716]

DisabRA also suggests that the Commission require providers to have policies allowing people with disabilities to drop inaccessible or inappropriate services from bundles, while still allowing them to take advantage of the reduced rates for other services included in bundles.[717] DisabRA prefers to have this principle established in Phase 1 with the details fine-tuned in Phase 2.[718]

B. Discussion: Full Pricing Flexibility for Bundles Containing Services Not Subsidized by CHCF-B or LifeLine is Reasonable.

Our statutory review and the positions of parties establish that there are no legal or policy barriers to increasing the pricing flexibility for bundles of telecommunications services. Indeed, increasing pricing flexibility would be more consistent with federal and state statutes that instruct us to encourage deployment of modern telecommunication services through use of pro-competitive policies. Our review of telecommunications markets also found that

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[714] Cox Opening Brief at 19.

[715] Comparison of URF Proposals.

[716] Id.

[717] Id.

[718] Id.; ORA Reply Comments at 11.

competitors check ILECs' market power: There is a single market for voice services, and no carrier has market power within California.

Our analysis in this section builds off of that contained in Section X. The tariffing and pricing reforms already adopted in this decision provide substantial pricing freedoms applicable to all services, except those services receiving subsidies. Since we can rely on the market to assure reasonable pricing of individual telecommunications services not receiving a subsidy, we conclude here that we also can rely on the market to assure the reasonable pricing of any bundle of services that does not include a service receiving a subsidy.

A similar analysis applies to tariffing and geographic service area issues. Consistent with our flexible tariffing of non-subsidized services in Section X, we hold that permitting flexible pricing of bundles that exclude basic service is reasonable on a one-day tariff filing. In accordance with our allowing different prices for non-subsidized services in different parts of a carrier's service territory, carriers may limit the offering of bundles to particular geographic areas.

These changes prompt elimination of other requirements too. Since we no longer need to rely on the imputation of costs to ensure that the prices of any tariffed service are reasonable, there is no reason to retain such a requirement for bundled services. There is no need to adopt regulations requiring special disclosures associated with a bundle of services either.

For services receiving subsidies – specifically LifeLine basic rates and basic residential rates in those areas receiving subsidies from the CHCF-B – we have not permitted pricing flexibility.[719] As our previous discussion of the issues made clear, the extensive subsidies provided by the LifeLine and CHCF-B programs are financed by charges on other end users and raised for a codified public purpose. These subsidies distort the market position of the services and technologies receiving subsidies versus those services and technologies that do not receive subsidies. Consequently, it is not appropriate to permit carriers to price these services with the same freedoms that apply to their other service offerings that compete in markets without subsidy.

The considerations that led to our restrictions on the general pricing of LifeLine residential service and basic residential service in areas receiving CHCF-B subsidies also require us to limit the inclusion of these services in bundles. Because rates are subsidized in both LifeLine service and in certain high-cost wire centers, we prohibit offering of bundles that include either (a) Lifeline services or (b) basic residential services offered in those wire centers where services receive a CHCF-B subsidy.

Finally, as we have noted in previous sections, the issues raised by DisabRA are best considered in R.06-05-028. The latter rulemaking will specifically review services that affect the disabled community.

In summary, bundles may include any telecommunications service not receiving a LifeLine or CHCF-B subsidy. Bundles can be tariffed under the same rules that apply to the tariffing of any telecommunications services and may be geographically targeted.

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719 We note that for LifeLine services, we are currently investigating policies in R.06-05-028. For basic services in areas receiving CHCF-B subsidies, we have prohibited pricing flexibility until R.06-05-028 addresses this and other issues associated with this subsidy.

C. Position of Parties on Promotions

The ILECs, DOD/FEA, and DRA agree that there should not be any limitations on promotions.[720] AT&T would provide a one-day notice following submission of a letter to the Commission's Executive Director.[721] DOD/FEA also recommends the one-day notice.[722] DRA proposes that there be an informational advice letter only, and have the advice letter be subject to protest in some cases.[723]

Cox, Time Warner, and CCTA recommend limiting promotions for the same service to ninety days in a twelve-month period and retaining the ILEC price floor requirements for promotions. These parties further urge the Commission to forbid geographic-specific promotions and promotions that involve any service or bundle containing a CHCF-B subsidized service.[724] Cox argues that the "large ILECs should be prohibited from conducting promotions that are based on the geographic location of the customer, as this would obviate the restrictions on geographic deaveraging."[725]

TURN and DisabRA also support maintaining the ninety-day limit on promotions and the rule that promotions beyond ninety days must be offered for

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720 Comparison of URF Proposals; Citizens Reply Brief at 3; SureWest Reply Brief at 3; SBC Reply Brief at 50; Verizon Reply Brief at 11; DOD/FEA Reply Brief at 5; ORA Reply Comments at 12.

721 Comparison of URF Proposals.

722 Id.

723 Those cases would be determined in Phase 2. Id.

724 Comparison of URF Proposals; Cox Opening Brief at Page 21.

725 Cox Opening Brief at 23.

resale.[726] DisabRA additionally asks the Commission to require providers to make customers with disabilities aware of the services and products that are provided for their benefit. This principle would be established in Phase 1 with the details fine-tuned in Phase 2.[727] According to DisabRA,"[p]roviders need to do a better job of letting Californians with disabilities know what is available. . . . This information could be disseminated to consumers' – on the providers' websites and through billings and other mailings. This is one of the most important protections for the Commission to include in the regulatory framework, and it is one of the easiest for providers to adopt and the Commission to enforce."[728]

D. Discussion: Full Pricing Flexibility for Promotions Concerning Services Not Subsidized by CHCF-B or Lifeline is Reasonable

Our statutory review and the positions of parties demonstrate that increasing the pricing flexibility for promotions complies with, and supports, California's telecommunications policies. Promotions are simply a way of marketing voice services to meet the needs of customers and market imperatives. Since we can rely on the telecommunications market generally to assure the reasonable pricing of individual services, we accordingly can rely generally on the market to assure the reasonable pricing of promotions.

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726 Comparison of URF Proposals; TURN Reply Comments at 13.

727 Comparison of URF Proposals; DisabRA Opening Brief at 24.

728 DisabRA Opening Brief at 24.

Also we note that federal regulatory policy requires that a carrier's promotions lasting longer than ninety days be subject to resale requirements. This federal provision places an appropriate limit on use of promotions, and we are confident that California can rely on this regulatory protection. We see no need to otherwise impose restrictions on the duration of promotions.

Finally, we find that just as it is inappropriate to permit pricing flexibility for services receiving subsidies from either the LifeLine or the CHCF-B program, it is inappropriate to include subsidized services in promotions. Promotions, consequently, cannot be linked to LifeLine service in any way, and they cannot apply to basic residential rates in areas receiving a CHCF-B subsidy.

In summary, all carriers should face similar rules concerning the initiation and withdrawal of promotions. It is reasonable, therefore, to permit pricing flexibility for promotions not including services that receive LifeLine or CHCF-B subsidies. Promotions may be geographically targeted and should be tariffed under the same one-day rules that apply to the tariffing of any telecommunications service.

XII. Grandfathering and Withdrawal of Services

Our existing policy regime largely treats the grandfathering and withdrawal of service as a standard tariff change that must be filed thirty days in advance of effectiveness and include a twenty-day protest period. The utility also must give affected customers notice twenty-five days in advance of the effective date of the change.[729] This section reviews proposals for modifying our current treatment of grandfathering and withdrawal of services.

[729] See D.02-01-031, Appendix, page A-1.

A. Position of Parties

AT&T urges the Commission to remove all restrictions on grandfathering[730] and withdrawal of residential and business services, so long as the services at issue are not basic residential or business access line services.[731] Under AT&T's proposal, the withdrawal or grandfathering of service would go into effect via a one-day tariff filing, but that the tariff must include a twenty-five-day notice period, with notice completed "25 days in advance of 'the requested effective date of the advice letter proposing the change, or the date when the utility submits the advice letter, whichever date is earlier.'"[732]

AT&T maintains that new services are being rapidly developed and deployed in the competitive telecommunications marketplace, and as new and innovative services stream into the market, all competitors should be free to discontinue offering outdated services without unnecessary regulatory delay.[733] In particular, it argues that it "makes little sense to interfere with the dynamic interplay of technology and customer product selection by arbitrarily requiring certain competitors to follow burdensome and time consuming procedures to grandfather or withdraw services while others need not."[734]

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730 A means of administering a tariff for an obsolete service, so as to halt the growth of service; ultimately, discontinue the service altogether, or change existing tariff regulations without discontinuing certain rights, privileges, or conditions of service to existing customers.

731 Pacific Bell Opening Brief at 60.

732 Id. at 83.

733 Id. at 61.

734 Pacific Bell Opening Brief at 60-61.

Frontier and SureWest assert that there should be no restriction on ILEC withdrawal or grandfathering of services other than basic local services.[735] The mid-size ILECs claim that there is no rationale for restricting withdrawal or grandfathering of other services.[736]

TURN and DRA oppose the ILECs' proposals to permit services, other than residential and business access lines, to be grandfathered or withdrawn on one-day advice letters.[737] TURN and DRA contend that this proposal would not provide sufficient time for parties to protest or for Commission staff to determine the effects of a decision to grandfather or withdraw service.[738]

TURN reminds the Commission that it has previously affirmed that adequate notice to consumers, specifically with regards to withdrawal of service and rate increases, is a crucial consumer protection. TURN cites the following portion of the Commission's decision in D.02-01-038:

> We are convinced that prior notice to customers is necessary and appropriate in the circumstances covered by the requirements we adopt today. Our experience in many complaint proceedings and investigations conducted since we last took a broad look at customer notice requirements in the telecommunications industry shows that inadequate information, misinformation, and customer confusion in this industry are far too prevalent. Prior notice to customers will not hamper legitimate competition; in fact, our new notice requirements

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735 Citizens Opening Brief at 27; SureWest Opening Brief at 30-31.

736 Citizens Opening Brief at 27; SureWest Opening Brief at 30-31.

737 Comparison of URF Proposals; TURN Opening Brief at 39.

738 TURN Opening Brief at 39.

> will help ensure that customers get what they want and like what they get.[739]

TURN argues that the same requirements applying to proposed price increases should similarly apply to advice letters dealing with grandfathering or withdrawal of service.[740] According to TURN, Commission staff should be able to verify, for example, the number of customers subscribing to a service and determine whether these customers have alternatives that are comparable in terms of function, price, and quality.[741]

DRA declares that any decision to grandfather and/or withdraw the existing price-capped services should occur only after all affected parties have had adequate notice and opportunity to be heard.[742] Specifically, DRA urges us to maintain the current twenty-five-day notification requirements for advice letters seeking withdrawal, and to permit them to become effective after thirty days only if there is no protest, as set forth by D.02-01-038. DRA raises the concern that the well-being of vulnerable customers otherwise could be endangered due to inadequate notice requirements for service withdrawal.[743] DRA notes that DisabRA cautions that there are services other than basic

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739 TURN Reply Brief at 45 (citing Second Interim Opinion Adopting Certain Requirements for Notifying Telecommunications Customers of Proposed Transfer, Withdrawal of Service, or Higher Rates or Charges, D.02-01-038, 2002 Cal. PUC LEXIS 34 (2002)).

740 TURN Opening Brief at 39.

741 TURN Opening Brief at 39.

742 DRA Reply Brief at 29.

743 Id. at 28.

residential and business access line services that may be essential to some customer groups, such as disabled customers, even when they are not essential for the broader population.[744]

DRA also advocates that the Commission not permit the ILECs to grandfather and withdraw *any* service for which price caps are retained.[745] It reasons that such services are, by definition, essential services for which competitive alternatives cannot protect consumers from price-gouging.[746]

B. Discussion: Tariffs Become Effective on a One-Day Filing, but Require Twenty-Five-Day Advance Notice to Affected Customers

Statutory policies and the level of market competition advise against the continuation of monopoly era regulations that limit the ability of carriers to withdraw or grandfather services that are no longer attractive to customers. In particular, these regulatory policies are incompatible with statutory instructions to encourage development of *new* technologies by using technologically and competitively neutral measures.

With the wide availability of communications alternatives from voice competitors, we see no reason to impose regulatory requirements on ILECs that we do not impose on other carriers. We, therefore, make a tariff to withdraw and/or grandfather services effective on a one-day filing, but the carrier must provide a twenty-five-day or more advance notice to the customer before withdrawing or grandfathering the service.

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744 Id.; DRA Opening Brief at 22-23.

745 DRA Reply Brief at 28.

746 Id.

We find that this proposed procedure and its twenty-five-day notice requirement is exactly the customer notice envisioned in the January 2002 Commission decision cited by TURN. We concur with DRA that the twenty-five-day advance notice will serve the disabled community with the notice that they need to find alternative service, but we see no need to impose the further limitation of a 30-day period before the tariff becomes effective.

Thus – with the exception of basic residential (1MR and 1FR) and basic business (1MB) services, where the withdrawal of service would raise public safety issues – we see no reason for imposing limitations beyond requiring a one-day filing period before which the advice letter becomes effective and twenty-five-day notice in advance of the withdrawal or grandfathering of any service.

XIII. Service Quality Requirements

Service quality standards are subject to General Order 133-B. A number of other carrier-specific service standards also have developed over time. These issues are under active consideration in R. 02-12-004.

A. Position of Parties

AT&T contends that service quality regulations and marketing rules, such as customer disclosure rules, should apply uniformly to all carriers.[747] It proposes that the Commission affirm that service quality regulation is uniform for all carriers, and any existing service quality requirements not uniformly applied to all carriers should be eliminated.[748]

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[747] Pacific Bell Opening Brief at 71-72.

[748] Comparison of URF Proposals; Pacific Bell Opening Brief at 4, 72-73.

Similarly, AT&T urges the Commission to adopt a policy in this phase that any customer disclosure information requirements should be applied uniformly across all market participants to the extent reasonably feasible.[749] It contends that any existing customer disclosure information requirements not uniformly required of all carriers should be eliminated.[750] At the workshop, AT&T concurred with DRA's proposal to discuss the specifics about monitoring reports in a follow-up workshop and address service quality issues in Phase 2 of this proceeding.[751]

Verizon discusses service quality as it is reviewed within the monitoring reports. In general, Verizon maintains that URF-specific monitoring reports should avoid duplication, and be limited to those that are consistent with the OIR's goals and vital to studying the effectiveness of the adopted framework.[752] According to Verizon, its proposed framework is self-effectuating and, therefore, can be implemented expeditiously without the need to address specific details in Phase 2.[753] Verizon's proposal for Phase 2 is for the Commission to have the parties, through workshops, quickly identify any URF-specific monitoring reports that are needed to replace the existing NRF monitoring regime.[754]

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[749] Pacific Bell Opening Brief at 71-72.

[750] Id.

[751] WS-2 Tr. at 172.

[752] Verizon Opening Brief at 4,5.

[753] Id. at 4.

[754] Verizon Opening Brief at 4-5.

Frontier and SureWest observe that customer service is an important concern of the Commission: one in which it has achieved excellent results by constantly prioritizing the issue.[755] The mid-size ILECs add that no party disputes this contention, and no matter what framework the Commission ultimately adopts, this priority should not change.[756]

Frontier and SureWest caution, however, that this proceeding should not be diverted or delayed in order to investigate or devise new rules regarding ILEC or industry service quality.[757] Instead, they recommend that the issue be referred to R.02-12-004, the existing rulemaking addressing service quality issues. Frontier and SureWest add that the Commission should make any future service quality rules applicable industry-wide.[758]

DRA comments that the record on URF monitoring requirements was poorly developed.[759] Consequently, it recommends that related details be developed in a follow-up workshop in which the experts compare notes, ask each other questions, and discuss the issue.[760] The monitoring requirements then need to be tailored to whatever pricing scheme is adopted. DRA contends that until the Commission selects an overall regulatory framework, it is very difficult

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[755] SureWest Opening Brief at 32; Citizens Opening Brief at 28.

[756] SureWest Opening Brief at 32; Citizens Opening Brief at 28.

[757] SureWest Opening Brief at 32; Citizens Opening Brief at 28.

[758] SureWest Opening Brief at 32; Citizens Opening Brief at 28.

[759] WS-2 Tr. at 63.

[760] Id.

to talk concretely about what to monitor.[761] It also proposes that parties address service quality issues in Phase 2.[762]

DisabRA points out that many Californians with disabilities are inadequately informed about what accessible and disability-related services and products are offered by providers. Even where providers do offer accessible products or services, or there is adaptive equipment that makes such products or services functionally accessible, "[a] lot of people with disabilities do not know that there's anything available to them."[763]

Consequently, DisabRA recommends that the Commission require all providers to inform customers and potential customers with disabilities about the accessibility of their products and services, including the availability of adaptive equipment, and about all disability-related products and services that they offer.[764] This information could be disseminated in the same ways that other required information is disseminated to consumers – on the providers' websites and through bills and other mailings.

DRA further urges the Commission to monitor the quality of services provided to Californians with disabilities.[765] In this phase of the proceeding, DisabRA asks the Commission to acknowledge that specific monitoring and auditing requirements are necessary in order to ensure that Californians with

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[761] Id.

[762] Comparison of URF Proposals.

[763] DRA Opening Brief at 23-27.

[764] DisabRA Opening Brief at 24.

[765] Id. at 23.

disabilities receive reasonably high quality service.[766] It suggests that details of such requirements can be established in Phase 2.[767]

Finally, DisabRA asks the Commission to extend the Deaf and Disabled Trust Program (DDTP) to have it cover additional technologies.[768] It maintains that such an extension would encourage investment in adaptive technology, greatly improve access to the network the disabled, and expand the telecommunications options for the disabled community.[769] DisabRA urges the Commission to recognize in this phase that both the maintenance and expansion/extension of the DDTP program are necessary in order to ensure that Californians with disabilities have access to affordable and accessible telecommunications services.[770]

B. Discussion: Service Quality Issues are Best Addressed in R.02-12-00

In the OIR, the Commission specifically excluded issues related to the quality of service provided by AT&T and Verizon to other carriers.[771] The Commission also deferred a long set of service quality issues to Phase 3 of the NRF (R.01-09-001/I.01-09-002) proceeding.[772]

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[766] Id.

[767] Id.

[768] Id. at 26.

[769] Id.

[770] Id.

[771] OIR, App. A.

[772] OIR, App. A.

Subsequently, on May 25, 2006, the Commission issued D.06-05-024, which resolved all of the outstanding issues of the fourth triennial review.[773] This decision noted that the regulatory framework adopted in this proceeding likely would replace NRF. After receiving comments from the parties, the Commission closed R.01-09-001 and I.01-09-002. We held that most of the issues were superseded by issues in this proceeding.

On a separate track, the Commission opened Service Quality OIR 02-12-004 at the end of year 2002. There the Commission noted that it first developed industry-wide telecommunications service quality rules in 1970, and formulated standard telephone service indices for all telephone carriers[774] by establishing General Order 133.[775] Incremental changes were made to General Order 133 in 1983, resulting in General Order 133-A,[776] [777] and additional

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[773] Decision Closing the Proceeding and Canceling the Rehearing of Decision (D.) 03-10-088 ordered by D.04-07-036 and D.04-12-024, D.06-05-024, 2006 Cal. PUC LEXIS.

[774] One-half of service penalty of 0.2 percent in rate of return imposed by D 75873 removed upon finding that *Gen. Tel. Co. of Cal* . has improved its services; *Gen. Tel. Co. of Cal* . ordered to submit new survey of adequacy of service in pending Application No. 51904, D.77947 (1970), 71 CPUC 550.

[775] Order Instituting Rulemaking on the Commission's Own Motion into the Service Quality Standards for All Telecommunications Carriers and Revisions to General Order 133-B, R.02-12-004 (2002), 2002 Cal. PUC LEXIS 868 (hereinafter R.02-12-004) (citing General Order No. 133, governing standards of telephone service, adopted, D.80082, 73 CPUC 426).

[776] R.02-12-004 (citing Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, practices, contracts, service and facilities of General Telephone Company of California, a California coporation; and of the Pacific Telephone and Telegraph Company, a California coporation; and of all telephone corporations listed in Appendix A, attached hereto, D.83-11-062 (1983), 13 CPUC2d 220 (hereinafter D.83-11-062)).

incremental changes to General Order 133-A in 1992, resulting in General Order 133-B. [778]

In order to reflect current technological and business conditions, the service quality OIR now seeks to adopt revisions to existing service quality measures and standards[779] applicable to telecommunications carriers.[780] The Service Quality OIR set out the following goals for the proceeding: to determine the types of services for which measures and standards should apply; the kind of measures and standards that should apply to those services; the methods for calculating measures; the minimum levels that measured parameters of service should meet (i.e., "standards"); when and how the measures should be reported to this Commission; and the mechanisms that will be used to ensure compliance with established requirements.[781] As evidenced by our discussion of the position of the parties, the parties in this proceeding did not present anything in detail regarding service quality issues like these described in the Service Quality OIR.

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777 R.02-12-004 (citing D.83-11-062).

778 R.02-12-004 (citing In the Matter of Amending Certain Clauses in General Order 133-A, Governing Service Standards for Telephone Companies, D.92-05-056 (1992), 44 CPUC2d 437).

779 "Measures" are the aspects or features of service subject to evaluation and reporting. "Standards" are the minimum acceptable values that measures must meet to be in compliance with the Commission's requirements.

780 Consistent with our Consumer Protection Rules, we define "carrier" under our service quality rules to include all entities, whether certificated or registered, that provide telecommunications-related products or services and are subject to the Commission's jurisdiction pursuant to the Public Utilities Code.

781 R.02-12-004, mimeo at.4.

Rather than attempt to take up these issues today, we believe that the Service Quality OIR offers the most appropriate venue for determining how the Commission should act to promote service quality in this new competitive telecommunications setting. We, therefore, defer all service quality issues to that proceeding. Further issues relating to the Deaf and Disabled Telecommunications Program are to be addressed in R.06-05-028, our Universal Service rulemaking on public policy programs.

XIV. Monitoring, Audit, and Reporting Requirements

ILECs must maintain two sets of regulated books. The first set is required by the FCC pursuant to Part 32 Uniform System of Accounts. The second set is designated for California specifically. The Commission requires books reflecting state accounting rules, which differ in many ways from the FCC rules.

Overall, the parties are in agreement that California should streamline its monitoring and auditing requirements.[782] There are clear distinctions between certain positions, however, in terms of the extent of the refinement and the timing. This section describes and assesses these various positions.

A. Position of Parties

AT&T recommends that the Commission eliminate California-specific accounting rules. According to AT&T, the California accounting requirements "are for the most part legacy requirements, and they only made sense in the context of cost-of-service regulation or a regulatory regime that otherwise regulates earnings. There is no longer a justification for maintaining these

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[782] See Comparison of URF Proposals.

outdated regulatory accounting requirements."[783] AT&T adds that currently "regulatory audits are not performed uniformly across all carriers."[784] The ILEC complains that its most recent audit "cost millions of dollars and resulted in protracted litigation" and "did not result in any tangible benefit to customers."[785]

Instead, AT&T recommends that the Commission defer to the FCC accounting requirements. Specifically, AT&T asks that the Commission take the following steps in this decision regarding the monitoring program:[786]

- Adopt a policy that it will no longer conduct lengthy and burdensome regulatory audits, and that requirements for regulatory audits be met in a uniform manner across all regulated telephone companies.
- Eliminate all existing company-specific monitoring program requirements. For AT&T, this means elimination of the NRF monitoring program.
- Adopt a policy that requires proposals for monitoring reports to be accompanied by a showing that the report is necessary and that the benefit of the report outweighs its cost.
- Adopt a policy that all monitoring requirements be applied uniformly to all telecommunications providers in Phase 2.

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783 Pacific Bell Opening Brief at 64.

784 Id. at 64.

785 Id. at 65.

786 Id. at 63-69.

- Adopt a policy that all monitoring requirements have sunset provisions to ensure that such requirements are not maintained beyond their usefulness.[787]

AT&T argues that adoption of its proposals would "further uniformity in industry accounting requirements while reducing the cost of regulation."[788] It suggests that, in Phase 2, the Commission then can determine the best approach through which it can fulfill its statutory audit obligations, and implement the monitoring policies adopted in this decision.[789]

Verizon agrees that the Commission should eliminate the detailed monitoring reports that have grown up in the NRF regulatory program. Specifically, Verizon recommends that "[e]xisting NRF monitoring reports would be replaced by FCC ARMIS reports and supplemented with limited URF-specific reports, to be determined in Phase 2."[790] Verizon envisions Phase 2 of this proceeding as the appropriate venue "to identify any URF-specific monitoring reports that are needed in addition to FCC ARMIS reports to replace the existing NRF monitoring regime."[791] Concerning financial reports, Verizon states that monitoring and auditing of ILEC earnings are warranted by the need for "ratemaking" adjustments, and it recommends that the Commission adopt the approach it instituted for AT&T in D.93-02-010, where periodic staff review

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787 Id.

788 Id. at 64.

789 Id. at 65.

790 Verizon Opening Brief at 4.

791 Id. at 4-5.

of the accuracy of monitoring reports was found to satisfy any auditing requirements under the Public Utilities Code.[792]

Likewise, Frontier and SureWest recommend that the Commission eliminate or reduce the monitoring reporting requirements and eliminate earnings audits.[793] They too ask that the Commission conform its accounting rules to ARMIS financial reporting requirements.[794]

DRA argues that monitoring, reporting, and audits of the ILECs are necessary during the transition to a fully competitive market. It declares that "in a new competitive world, monitoring will continue to play an essential part of any comprehensive oversight program. Absent monitoring, the CPUC will not be able to determine if any new framework is meeting or defeating the CPUC's stated goals."[795] DRA specifically references the OIR and Public Utilities Code §§ 709(f) and (h) when setting out the Commission's goals, and it voices concerns that the ILECs' proposals do not adequately reflect statutory goals of "promot[ing] low prices" and "fair treatment of consumers" that are established in §§ 709(f) and (h), respectively.[796]

DRA contends that if the Commission is serious about ensuring that these goals are met, then it must adopt an effective monitoring program. DRA suggests that the Commission needs better information about competition in

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[792] Id. at 28-31.

[793] Citizens Opening Brief at 27-28; SureWest Opening Brief at 31-32.

[794] Citizens Opening Brief at 27-28; SureWest Opening Brief at 31-32.

[795] DRA Reply Brief at 15.

[796] DRA Reply Brief at 13-14.

California, and can obtain such data, in the future, through monitoring.[797] It also asserts that different levels of market power warrant differing degrees of reporting and auditing requirements.[798]

Finally, DRA supports the ILECs' position that the specifics of these issues can be best addressed in Phase 2.[799] DRA notes that a workshop would be the more efficient method to address the details of the monitoring programs applicable to the ILECs.[800]

DisabRA asks the Commission to acknowledge in Phase 1 of this proceeding that specific monitoring and auditing requirements are necessary in order to ensure that Californians with disabilities receive reasonably high quality service.[801] DisabRA also agrees that the details of such requirements can be established in Phase 2.[802]

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797 Id. at 15.

798 Id. at 17.

799 Id. at 15-16.

800 Id. at 15-16.

801 DisabRA Opening Brief at 23.

802 Id. at 23-27.

B. Discussion: Accounting and Reporting Should Follow National Standards; Audits Should Follow Approach Adopted in D.93-02-010; NRF-Specific Monitoring Reports Are Suspended; URF Monitoring Reports Are Considered in Phase 2

An apt starting point for our discussion is Public Utilities Code § 314.5. This section is the statutory basis of our auditing requirements:

> The commission shall inspect and audit the books and records for regulatory and tax purposes (a) at least once in every three years in the case of every . . . telephone . . . corporation serving over 1,000 customers, and (b) at least once in every five years in the case of every . . . telephone . . . corporation serving 1,000 or fewer customers. . . .[803]

The statute uniformly requires an audit every three years for all telephone companies with over one thousand customers.[804]

Despite the uniform applicability of the statute, the Commission has not conducted uniform audits across the carriers. Moreover, as noted by AT&T, the most recent audits have been extensive, have led to minor adjustments, and have produced no tangible benefits for ratepayers. Indeed, the design of the previous NRF sought to reduce the need for the extensive audits that characterized ROR regulation, and it is a measure of the success of this program that extensive audits have led to no changes for ratepayers.

DRA's cites Public Utilities Code §§ 709(f) and (h) in support of its request for continued auditing and monitoring, but DRA has failed to provide a logical nexus between the code section and its request. That is, DRA has not shown that

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803 CAL. PUB. UTIL. CODE § 314.5.

804 In California, that would be over 1,300 carriers.

an extensive audit is necessary to "promote low prices" or "fair treatment of consumers." We further note the Section 709(g), a piece of Section §709 not cited by DRA, states that California policy is to promote "fair product and price competition in a way that encourages greater efficiency, lower prices, and more consumer choice."[805] Conducting extensive audits for one or two carriers that produce no tangible results is inconsistent with this statutory policy.

To comply with the statutes encouraging uniform treatment of carriers and efficient regulation, we adopt the policy that we instituted for AT&T in D.93-02-010, where periodic staff review of the accuracy of monitoring reports was found to satisfy any auditing requirements under the Public Utilities Code.

Concerning accounting standards, there is no reason to continue to require a set of regulatory accounts with California jurisdictional adjustments. Since the regulatory adjustments no longer serve a ratemaking purpose, the only result of the requirement is to create a confusing proliferation of regulatory accounts that make utility operations less transparent. For these reasons, therefore, we adopt the FCC standard accounting practices for California carriers.

With respect to monitoring reports, we eliminate all NRF-specific monitoring reports and choose to rely on the FCC ARMIS data. Our experience over the last several years indicates that these NRF-specific detailed reports were little used. Yet the points raised by DisabRA and TURN – i.e., better information on competition and on the effects Californians with disabilities can be useful to the Commission – are well taken. Thus, we adopt their recommendation that

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[805] CAL. PUB. UTIL. CODE § 709(f).

Phase 2 should determine what information and what reports can best meet the Commission needs in the new competitive environment.

In determining specific new reporting requirements, we concur with AT&T that those proposing reporting requirements should be accompanied by a report showing that the projected benefits outweigh the costs of providing the report. We also agree with DRA that workshops provide the appropriate venue for initiating an investigation into Commission needs, public benefits, and reporting costs. We, therefore, will schedule workshops to launch this inquiry. It is our intention to ensure that the Commission has all the information it needs to fulfill its statutory obligations, while avoiding the collection of data that imposes asymmetric or unnecessary costs on only certain market competitors.

XV. Allocation of the Gain or Loss from the Sale of Utility Property

The allocation of the gain or loss on the sale of utility asset for utilities subject to cost-of-service regulation is determined by D.06-05-041. However, R.04-09-003, the proceeding that set these policies, referred gain-on-sale issues for telecommunications utilities subject to NRF regulation to this proceeding.

Current Commission policies applied to Verizon provide gains on the sale of assets other than land to shareholders.[806] Gains from the sale of land are allocated according to a formula adopted in a settlement:

> Gains on the sale of Verizon's land and assets are treated for regulatory purposes in three ways, depending on the type of property being sold. First, gains on the sale of land have been

[806] Cleverly Opening Comments at 11.

[806] Cleverly Opening Comments at 11.[806]

> subject to the terms of the settlement agreement in D.93-09-038. Second, gains on the sale of depreciable assets are accounted for in accordance with FCC Part 32, with no impact on net income. Third, gains on the sale of distribution systems, such as entire exchanges, are recorded as miscellaneous operating income.[807]

With the elimination of shareable earnings for Verizon, the net effect is that all gains on sale of land acquired since the start of NRF are returned to shareholders, while the gains on the sale acquired before the start of NRF are split between shareholders and ratepayers according the formula contained in appendix B of D.93-09-038.

For AT&T, under current NRF policies, one hundred percent of the gain or loss of utility property are provided to shareholders, with one exception. That exception pertains to the allocation of the gain from the sale of land purchased prior to the adoption of NRF. Pursuant to a settlement between DRA and Pacific Bell adopted in D.94-06-011, the Commission has treated gains-on-sale pursuant to a complicated schedule based on the amount of time an asset has been in ratebase and the amount of time it has been out of ratebase.[808] For land assets

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[807] Cleverly Opening Comments at 11.

[808] The settlement concerning the allocation of gain-on-sale is contained in Appendix B of <u>Application of GTE California Incorporated (U 1002 C) for review of the operations of the incentive-based regulatory framework adopted in Decision 89-10-031; In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for review of the regulatory framework adopted in Decision 89-10-031; And Related Matters</u>, D.94-06-011, 55 CPUC2d 1 (1994), 1994 Cal. PUC LEXIS 456. In relevant part, it sets out the following schedule:
Pre-NRF Purchased Land

- Pre-NRF: 100% of GSL [Gain on the Sale of Land] not previously recognized in the attrition mechanism should be returned to ratepayers through a rate adjustment in the next annual Price Cap Filing.

Footnote continued on next page

acquired after the start of NRF, the gain on the sale of land is booked "above the line" and subject to earnings sharing. With the elimination of sharing, all gains from the sale of land acquired after the start of NRF are returned to shareholders.

A. Position of Parties

Verizon recommends that the Commission end the NRF era gain-on-sale policies.[809] It argues that it should be treated no differently than its competitors, due to the competitive risks in the market today and the OIR's goal of competitive neutrality.[810] Verizon also cites many cases in support of its argument that gains or losses on asset sales should be allocated to the shareholders who have borne the risks of the

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- 1990-1993: 100% of GSL should be returned to ratepayers through one-time Price Cap rate adjustments in the annual Price Cap filings.
- 1994-1996: A prorated amount of the GSL should be returned to ratepayers through one-time rate adjustments in the annual Price Cap filings using a method based on the relative years that a parcel was held prior to NRF in plant-in-service to its total operating service life. For example, if a land parcel purchased in 1981 was sold in 1995, 60% or 9/15th's of the GSL should be accrued to ratepayers. The residual prorated amount not returned to ratepayers should be treated ATL for Sharable Earnings consideration.
- 1997 & Beyond: 50% of pre-NRF GSL should be returned directly to ratepayers as one-time rate adjustments in the annual Price Cap filings. The remaining 50% should go to shareholders.

Post-NRF Purchased Land

- All GSL should be treated ATL [Above the Line] for Sharable Earnings consideration.

[809] Verizon Reply Brief at 19.

[810] Id. at 19-20.

investments.[811] According to Verizon, "[s]hareholders bear all the risks associated with investment; accordingly, they should retain the gains or bear any losses from the sale of assets."[812] Verizon adds that between the settlement in 1993 and 2004, the sale of land produced a gain for distribution to ratepayers in only one year.[813]

AT&T states that, in NRF, the Commission "correctly shifted the risks of investment in long-lived infrastructure facilities to the ILEC shareholders."[814] According to AT&T, our current treatment of gains on sales of land, however, is at odds with the fundamental shift of risk from ratepayers to shareholders under NRF.[815] Accordingly, AT&T urges removal of any requirement to allocate gains or losses on the sale of assets to ratepayers.[816] The ILEC argues that risks borne by shareholders are

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811 Verizon Reply Brief at pp. 19-21. See, e.g., Board of Public Utility Commissioners v. New York Telephone, 271 U.S. 23, 31–32 (1926) ("Customers pay for service, not for the property used to render it. . . . By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for services belongs to the company."); Maine Water Co. v. PUC, 482 A.2d 443 (ME 1984) (ratepayers have "no rationally supportable claim to any flow-through of the benefit of the gain the Company realized in selling [its properties]"); Appeal of Nashua, 435 A.2d 1126 (NH 1981) ("profits from the sale of fixed capital belong to the stockholders rather than the ratepayers"); Boise Water Corp. v. Idaho PUC, 578 P.2d 1089 (ID 1978) (ratepayers are not entitled to reap the rewards or losses on the sale or transfer of utility land).

812 Verizon Opening Brief at 31.

813 Cleverly Opening Comments at 12.

814 Harris Opening Comments at 6.

815 Pacific Bell Opening Brief at 68.

816 Id.

"greater than ever," and gains on the sale of all assets should accrue to shareholders.[817] AT&T adds that any vestigial requirement to allocate gains to ratepayers skews investment decisions, creates disincentives to efficiently manage assets, and penalizes efficient investment.[818]

Citizens and SureWest state that there is "broad agreement" that gains on sale should be allocated to shareholders.[819]

DRA presented a set of reforms that combined new regulations with the elimination of requirements for sharing gain on sale. As part of this package DRA states that the Commission should eliminate the remaining gain on sale requirement as long as rates are frozen for stand-alone residential and business basic services.[820] DRA reasons that "a regulatory framework that allows ILECs to keep gains-on-sale while guaranteeing the availability of stand-alone residential and business basic services at current prices is much more pro-ratepayer than a framework that allows the ILECs to retain gains-on-sale while at the same time allowing them to raise basic service prices at will."[821]

Similarly, TURN and DOD/FEA contend that gains from the sale of pre-NRF assets should be allocated to ratepayers.[822] TURN argues that the ILECs' proposals fail to properly balance risk with reward:

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[817] Id. at 69.

[818] Id.

[819] Citizens Reply Brief at 2; SureWest Reply Brief at 19-21.

[820] DRA Reply Brief at 26.

[821] DRA Reply Brief at 26.

[822] TURN Reply Brief at 48-49; DOD/FEA Reply Brief at 8.

> While the Respondent ILECs are more than happy to appropriate the benefits of the ratepayers' risk taking, they also request that ratepayers continue to bear risk through a rate-of-return style revenue neutrality mechanism which will keep the companies "whole" should they face any access charge reductions while local exchange rates are subject to caps.[823]

DOD/FEA concludes that if an ILEC applies for an increase in basic rates under its regulatory proposal, then the ILEC "should be required to reflect an imputation of . . . and the gain on sale of rate base assets acquired prior to the implementation of the New Regulatory Framework ('NRF')."[824]

B. Discussion: All Gains or Losses from Sale of Utility Property Should Accrue to Shareholders

The link between costs and rates was broken nearly twenty years ago with the adoption of NRF. In only one situation has the Commission allocated any gain on sale to ratepayers: the sale of land acquired prior to the adoption of NRF. With the passage of time, more and more utility property falls into the area in which all gains or losses are allocated to shareholders. Even for land acquired prior to the adoption of NRF, the incumbent utilities have assumed all financial and operating risks that accrue to owners for the last twenty years.

Adopting a policy that allocates all gains or losses to shareholders will simplify the regulatory program and make it consistent with the economic principle that those who bear the risk should reap the rewards. We expect this reform will have a minimal impact on ratepayers. As Verizon's review of its records makes clear, under current rules, little gain is allocated to ratepayers

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[823] TURN Reply Brief at 48-49.

[824] DOD/FEA Reply Brief at 8.

despite complex calculations following a negotiated allocation rule, and elaborate record-keeping requirements.

We further note that the companies with which the ILECs compete retain all gains or losses from the sale of their utility property. Thus, adopting a policy that allocates one hundred percent of all gains and/or losses from the sale of property by ILECS to their shareholders will place ILECs on an even footing with their competitors. This reform serves our interests in promoting in fair competition between communications providers.

In summary, allocating one hundred percent of all gains and losses from the sale of land by ILECs is a modest revision of current rules, which already adopt this policy for property acquired in the last twenty years. Such a policy will have minimal impact on rates and is in harmony with the principle that those who bear the risk should reap the reward. Finally, such a policy is consistent with the rules under which carriers competing with ILECs now operate. Each of these reasons provides a rational basis for our decision to allocate all gains and losses from the sale of property by ILECs to shareholders.

XVI. Vestiges of Rate-of-Return Regulation, Including the Calculation of Rates of Return and Revenue Sharing

This section discusses many vestiges of earnings regulation that fall within the scope of Phase 1 of this proceeding, but are not mentioned elsewhere in this decision. These vestiges of earnings regulation include requirements concerning the calculation of the price cap index and earnings sharing.

The most controversial issue in this section concerns Yellow Pages directory earnings. The major point of contention over this issue is found in parties' interpretation of Public Utilities Code § 728.2(a):

> Except as provided in subdivision (b), the commission shall have no jurisdiction or control over classified telephone directories or commercial advertising included as part of the corporation's alphabetical telephone directories, including the charges for and the form and content of such advertising, except that the commission shall investigate and consider revenues and expenses with regard to the acceptance and publication of such advertising for purposes of establishing rates for other services offered by telephone corporations.

We review and assess parties' interpretations of this statute below.

A. Position of Parties

AT&T proposes a "permanent elimination of price cap and earnings sharing mechanisms, imputation of yellow pages directory earnings, and all other earnings-related requirements."[825] It argues that earnings regulation generally "distorts operating and investment decisions."[826] According to AT&T, earnings regulation "affects the financial expectations that are an integral part of such decisions, introducing uncertainty into present and future revenue streams. As a result, it can cause companies to delay or reject otherwise cost-effective investments. Earnings regulation thus fails to provide the correct economic incentives in a competitive telecommunications marketplace."[827]

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[825] Pacific Bell Opening Brief at 54-55.

[826] Id. at 54 (citing Harris Opening Comments at 49-51; Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell, 98-10-026, 82 CPUC 2d 325, 355 (1998)).

[827] Id. at 54 (citing Harris Opening Comments at 49-51; Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell, 98-10-026, 82 CPUC 2d 325, 355 (1998)).

As regards reporting requirements, AT&T asserts that "it makes no sense to eliminate earnings regulation but continue to impose earnings reporting requirements that are meaningful only in a framework that regulates earnings."[828] AT&T adds that imposing earnings requirements only on certain carriers "perpetuates asymmetric regulation, contrary to the Commission's objective of a uniform regulatory framework. . . . Indeed, a 'financial scorecard' that is based on Commission-imposed earnings conventions applied selectively to some carriers and not to others would be neither valid nor useful."[829] AT&T maintains that it would be better to eliminate earnings rules so that all companies would have the same incentives to reduce cost, introduce new services, and invest.[830]

With respect to Yellow Page directory earnings in particular, AT&T insists that Public Utilities Code § 728.2(b)(1) "applies only under specific, limited circumstances that have never existed."[831] The ILEC provides the following statutory analysis:

> Section 728.2(b) . . . would only apply if the Commission determined that "federal action would impair its ability to investigate and consider revenues and expenses with regard to the acceptance and publication of telephone directory advertising for the purpose of establishing rates for other services offered by any telephone corporation. . . ." The Commission has never had any reason to make such a determination. While § 728.2(a) states in part that the

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[828] Id.

[829] Id.

[830] Id. at 54 (citing Taylor Opening Comments at 28-29).

[831] AT&T Reply Brief at 55.

> Commission "shall investigate and consider revenues and expenses with regard to the acceptance and publication of such advertising for purposes of establishing rates for other services offered by telephone corporations," the Commission discontinued establishing rates for AT&T California based on a revenue requirement over 16 years ago, after it adopted NRF and a start-up revenue adjustment.[832]

AT&T adds that "earnings measures that include results from long-unregulated yellow pages advertising services provide no useful information about earnings from regulated telecommunications services. There is no longer any regulatory purpose served by imputing yellow pages directory earnings."[833] Cox agrees with AT&T's position on earnings regulation and Yellow Page earnings more specifically.[834]

Verizon proposes that earnings regulation, including California-specific "ratemaking" adjustments and the NRF earnings-sharing mechanism, be permanently ended.[835] It states that the Commission should no longer monitor earnings beyond any FCC ARMIS reporting requirements.[836] Verizon also asserts that the Commission "will have no need to monitor or impute directory revenues and expenses pursuant to Public Utilities Code section 728.2."[837]

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[832] Id. at 55.

[833] Id.

[834] Cox Reply Brief at 14 (citing Pacific Bell Opening Brief at 75).

[835] Verizon Opening Brief at 4.

[836] Verizon Opening Brief at 4.

[837] Id. at 18.

Regarding earnings regulation in general, Verizon states that "it is a fundamental concept of sound economics that regulated companies will not make investments if they believe that the regulator will expropriate the benefits of those investments. . . . Continuing earnings regulation, therefore, harms consumers by denying them the benefits of full investment."[838] Verizon adds that ending earnings regulation "would fulfill the policy direction charted by the Commission"[839] in a prior decision that held that we "expect permanent elimination as part of the evolution of our regulation in response to continued changes in the market."[840] We explained that "permanent elimination will remove regulatory risk, and provide desirable certainty to the market."[841]

Verizon opposes monitoring requirements too. It states that these requirements serve no useful purpose in a market driven industry.[842] Because such scrutiny is not applied to CLECs or to other intermodel competitors,

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838 Id. at 30 (citing Aron Opening Comments at ¶¶ 201–206; Aron Reply Comments at ¶ 132).

839 Id.

840 Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell, 98-10-026, 82 CPUC 2d 325 (1998), 1998 Cal. PUC LEXIS 669, 47.

841 Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell, 98-10-026, 82 CPUC 2d 325 (1998), 1998 Cal. PUC LEXIS 669, 47.

842 Verizon Opening Brief at 30.

Verizon argues it creates unnecessary burdens, litigation, deters investment, and is inconsistent with the goal of competitive and technological neutrality.[843]

Verizon further contends that Yellow Page earnings should not be reported. It argues that Public Utilities Code § 728.2(b)(1) "applies only when the Commission is 'establishing rates' for the incumbents. The Commission is not establishing rates in URF, so the code section does not apply."[844]

Frontier and SureWest assert that "all carriers should be unconstrained by earnings regulation, whether by earnings sharing or otherwise."[845] They also argue that "there is no justification for continuing to use unregulated directory advertising revenues to 'support' ILEC telephone services."[846]

With regards to earnings regulation, Frontier and SureWest contend that earnings regulation is "inappropriate and counterproductive" in a competitive marketplace: "In a competitive environment, carriers will naturally invest in the provision of services that offer a good return. Those services will offer a good return because of customer demand. . . . [A]ll competitors can direct investments to services that they believe are in greatest demand and will appeal to the maximum number of customers."[847]

Addressing Yellow Page earnings reporting, Frontier and Surewest argue that director advertising is a "highly competitive business":

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843 Id. at 29-31.

844 Verizon Reply Brief at 19.

845 Citizens Opening Brief at 23; SureWest Opening Brief at 27.

846 Citizens Opening Brief at 25; SureWest Opening Brief at 28.

847 Citizens Opening Brief at 23-24; SureWest Opening Brief at 27.

> There are many competitive directories, and white pages directories lost their copyright protection many years ago thereby eliminating a barrier to entry for competing directory providers. In addition, all directories compete with many other forms of advertising, including the internet. To compound this competitive situation, the services that directory advertising historically have been used to support are now competitive as well.

The mid-size ILECs conclude, therefore, that there "is simply no justification for continuing to use directory advertising revenues to subsidize any service or product, and directory advertising revenues should be decoupled from other intrastate revenues."[848]

DRA recommends that the Commission "no longer require California-specific adjustments as part of earnings monitoring beyond those required to implement California statutes and regulations."[849] DRA cites "simple 'overlays' to standardized Uniform System of Accounts (USOA) reporting to identify the effect on earnings of the incumbents' Yellow Pages . . . operations" as an example of monitoring for a statutory requirement. It further urges the Commission to "develop details of any California-specific earnings adjustments either in implementation workshops or in a later phase of this proceeding."[850]

Regarding Yellow Page earning monitoring more specifically, DRA argues that "[t]he coupling of yellow pages directory earnings and *rates* . . . is set forth in statute, and the CPUC cannot eliminate that coupling":

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848 Citizens Opening Brief at 25; SureWest Opening Brief at 28-29.

849 DRA Opening Brief at 10.

850 Id. at 11.

> The CPUC is statutorily required to consider yellow pages revenues and expenses in the setting of rates for "other services" the ILECs offer. At the same time, to the extent the CPUC chooses not to establish rates for services it deems fully competitive – as it has done with services presently in Category III under the New Regulatory Framework – then the CPUC would not have to consider yellow pages revenues in connection with those rates.

DRA concludes that "so long as the CPUC sets rates for any ILEC services, it must consider yellow pages revenues and expenses in the setting of those ILEC rates."[851]

Specific statutory considerations notwithstanding, DRA adds that "'decoupling' could result in harm to ratepayers by distorting the picture of the profitability that the Respondents derive from activities that are integrally related to their local exchange line of business."[852] It argues that since the ILECs "dominate the directory publishing industry,"[853] their directories are perceived to be the "official" white and yellow pages,[854] and as such "[t]he CPUC has consistently recognized the need to include directory publishing revenues and profits within the reported intrastate earnings of the major ILECs," the reporting practice should not change.[855] DRA adds that "[a] substantial body of regulatory and judicial decisions have concluded that directory advertising income is

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851 DRA Reply Brief at 26-27.

852 ORA Opening Comments at 48.

853 Id. at 49.

854 Id. at 50.

855 Id. at 50-51 (citing Interim Opinion Regarding Phase I Issues, D.02-10-020, 2002 Cal. PUC LEXIS 647, *mimeo* at 21-30).

properly considered attributable to the intrastate regulated telephone company's operations."[856]

TURN proposes that "for this transitional period, earnings regulation can be eliminated," but, consistent with DRA's recommendation, "ILECs should continue to report intrastate earnings according to Commission requirements."[857] TURN includes Yellow Pages earnings in its list of items that should continue to be reported.[858] It argues that the Public Utilities Code prevents "decoupling" of Yellow Page revenue: "The Commission is obligated to follow the requirements of P.U. Code § 728(2)(b)(1). . . . The Commission does not have the authority to alter this requirement."[859] TURN also echoes DRA's assertion that "'decoupling' could result in harm to ratepayers by distorting the picture of the profitability that the Respondents derive from activities that are integrally related to their local exchange line of business.'"[860]

DOD/FEA states that its proposal "would essentially eliminate earnings regulation."[861] While it would institute a revenue cap (described in Section VII), DOD/FEA would allow ILECs "to file for an increase to [their] basic local service revenue cap if it believes a significant revenue shortfall exists for these

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[856] Id. at. 50-51 (citing a number of other states' regulatory decisions).

[857] TURN Opening Brief at 40.

[858] Id. at 40-41.

[859] Id.

[860] Id. at 41 (citing DRA Opening Comments at 49).

[861] DOD/FEA Opening Brief at 13.

services."[862] This filing would "be required to reflect an imputation of Yellow Page revenues."[863]

Other parties do not specifically address earnings regulation or Yellow Page revenues.

B. Discussion: Vestiges of Earnings Regulation No Longer Serve the Public Interest

All commenting parties support the elimination of most PUC earnings regulation. Moreover, given our decision today, there is no longer a need for the NRF regulatory apparatus of price caps, annual price cap filings, "productivity factors," and "sharing of revenues" that are included in the price cap calculations.

ILECs are correct to argue that earnings regulation, like earnings sharing, distorts investment decisions. Firms factor in the risk of future regulation and its potential appropriation of gains in their investment decisions. While monitoring of Yellow Pages revenues and other regulatory accounts and adjustments may seem harmless, it is indeed a signal to firms that they should still factor a risk into their calculations. We also should take into account the need for monitoring. Here there is no justifiable need for monitoring, because of the competitive environment that exists today in telecommunications. Regular reports of "regulated" earnings can only distort firms' decisions and conflict with the reports required by financial markets.

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[862] Id.

[863] Id.

Market conditions also inform our interpretation of Public Utilities Code § 728.2(a). We observe that directory listings service for telephony has been long been de-regulated. This listing service is a competitive business that has significant competition not just with other white and yellow page books, but with other forms of advertising and, most significantly, the Internet. In light of this marketplace, we disagree with DRA's argument that only the ILEC's directory listing books are considered "official" books.

Moreover, as Frontier and SureWest point out, "the services that directory advertising historically have been used to support are now competitive as well."[864] So even if statute did require the reporting of Yellow Page earnings, this requirement nevertheless no longer pertains to today's marketplace. The statute applies only when the Commission is establishing rates: The law states "that the commission shall investigate and consider revenues and expenses with regard to the acceptance and publication of such advertising *for purposes of establishing rates for other services offered by telephone corporations*" (italics added).[865] As this Commission does not establish rates for telephone services, there is no requirement to consider this information further. We caution against putting form over substance, particularly when it disadvantages one market player over another in an unfair manner.

Therefore, we find it reasonable to end all the vestiges of the prior NRF and rate of return regulation. We eliminate price caps, the annual price cap

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864 Citizens Opening Brief at 25; SureWest Opening Brief at 28-29.

865 CAL. PUB. UTIL. CODE § 728.2(a).

filing, the productivity factor, and all residual elements of rate of return regulation, including the calculation of "shareable" earnings.

In addition, we end the reporting of Yellow Page revenues, because the reporting is not required by statute and serves no useful purpose. As discussed in Section XIV, we have determined to bring California accounting policies in line with standard accounting practices. Including Yellow Page "adjustments" would cause California accounts to depart from the standard accounting practices we pledged to use.

XVII. Assignment of Proceeding

Rachelle B. Chong is the Assigned Commissioner and Jacqueline A. Reed is the assigned Administrative Law Judge in this proceeding.

XVIII. Comments on Draft Decision

The draft decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure. Comments were filed on ________________ and reply comments were filed on ________________.

Findings of Fact

1. The New Regulatory Framework, "NRF," is eighteen years old and now outdated given market advances and statutory changes.

2. NRF predates the Telecommunications Act of 1996, which opened local telecommunications markets throughout the country to competition.

3. NRF predates the dramatic growth in the Internet, in wireless technology, cable modems, DSL, and the development of VoIP communications.

4. NRF has its roots in monopoly cost-of-service regulation, including price controls, earnings regulation, controls on the introduction of new services, price floors and extensive audit requirements.

5. This proceeding has included an En Banc hearing with presentations by expert analysts and academics of telecommunications markets and regulation.

6. This proceeding has included two workshops. One workshop addressed issues concerning the schedule and scope of the investigation. The second workshop explored the policy proposals of active parties for three days.

7. This proceeding has included four days of evidentiary hearings, including oral arguments to the Assigned Commission.

8. California statutes concerning telecommunications regulation express a clear desire to support open and competitive markets.

9. In the same Public Utilities Code section that states goals for telecommunications, the California Legislature also provides direct guidance on the means regulators should employ to achieve these goals.

10. California statutes also call for regulators to adopt technologically and competitively neutral policies that encourage increased access to and usage of advanced telecommunication services.

11. Current telecommunications regulations also support major social policies including the provision of telecommunications services to low-income Californians and the provision of affordable telecommunications services in high cost areas of the state.

12. It would not be possible at this time for the Commission to adopt a completely uniform regulatory framework that applied to all communications carriers because the Commission does not have jurisdiction over all communications service providers, such as rate setting authority over wireless carriers or Voice over Internet Protocol providers.

13. Parties developed a record that fleshed out two general policy alternatives: one that would afford greater pricing flexibility to the ILECs, and another that would maintain the *status quo*.

14. Economic theory indicates that a reasonably competitive market will, over the long term, yield a system of rates that approximate the costs of providing those goods or services.

15. Economic theory shows that the rates and range of services that result from a competitive market will likely be better than those that would arrive from a regulated market.

16. The survey data provided by Verizon, of customers who have "cut the cord," indicate that many customers do see mobile and landline telephony as close substitutes in the market.

17. VoIP services provide another close substitute to circuit switched communications services. VoIP frequently offers a better service with more features and functionalities at any given price point – for traditional circuit switched voice communications services.

18. VoIP provided by cable telephone companies is a direct substitute for circuit-switched wireline service.

19. The historic practice of defining each telecommunications service as constituting a separate "market" is no longer relevant in today's technologically diverse telecommunications environment.

20. The market analysis presented by at&t witnesses Harris and Taylor indicating the obsolescence of historic market distinctions was compelling. The market analysis presents a better explanation of the rise of competing technological platforms for providing telecommunications services.

21. A service need not be identical to provide a competitive substitute.

22. Telecommunications technology and products are constantly changing.

23. As competition expands consumer choice, all consumers, including the disabled benefit as long as the needs of this community are examined directly and protected from withdrawal of services.

24. A substitute provides competitive discipline in a market segment when it is available.

25. Market power is the ability of a company to sustain prices at levels above those a market would produce by restraining the supply of telecommunications services to the market.

26. Review of the extensive record in this proceeding shows that Verizon, at&t, SureWest and Frontier lack the ability to limit the supply of telecommunications services in telecommunications markets, and therefore lack the market power needed to sustain prices above the levels that a competitive market would produce.

27. This result holds throughout the service territories of Verizon, at&t, SureWest and Frontier, and holds for both business and residential services.

28. The FCC has found that competition in local communications markets is not impaired when UNE-L is available, even if UNE-P is not available.

29. Verizon, at&t, SureWest and Frontier are subject to the unbundling requirements of the Telecommunications Act of 1996.

30. Verizon demonstrated the federal program to open local markets to competition has resulted in the presence of competing carriers throughout its service territory.

31. Verizon and at&t documented that alternative technologies have provided realistic alternatives to wireline telecommunications service.

32. Verizon demonstrated that wireless technology is the "key killer" of primary consumer lines.

33. Verizon demonstrated that wireless substitution accounts for approximately half of ILEC primary residential wireline losses.

34. at&t has demonstrated that wireless, even when purchased in addition to a wireline connection, provides competitive pressure on landline services.

35. at&t demonstrated that wireless technology already exercises a competitive check on its provision of telecommunications services.

36. SureWest's market power is limited by the presence of six wireless carriers in its service territory, as well as by the unbundling scheme adopted by the FCC and by developments in VoIP technology.

37. Frontier shows that it faces competition from wireless and VoIP technologies and that it is also subject to unbundling requirements.

38. Wireless service is a substitute for wireline service.

39. The evidence available does not support the conclusion that wireless service is a complement to wireline service.

40. Wireless services are increasing their portion of total communications minutes and accounted for 23% of all minutes in 2003.

41. The growth in wireless minutes and its increasing share of total communications minutes indicates that the relevant market is voice communications services, not wireline communications services.

42. In California, broadband is ubiquitously available.

43. VoIP provides a competitive alternative to circuit switched telecommunications services wherever a broadband connection is available.

44. Verizon has shown that providers of VoIP communications services have used numbers associated with every Verizon wire center except one.

45. Experts forecast that by the end of 2006, 64% of U.S. household will have the option of purchasing VoIP telephony service from their cable companies.

46. Cox has achieved a 40% penetration of the telecommunications market in Orange County, California.

47. The provision of VoIP telephony service by a cable company requires minimal incremental investment with expert estimates in the $300 dollar range. Thus, entry into telecommunications markets by cable providers requires minimal capital investments.

48. Verizon has demonstrated the presence of CLECs, wireless carriers and cable providers of telephony service throughout its entire California service territory.

49. The calculation of HHI values provides no information relevant to our assessment of ILEC market power because rapidly changing technological and market conditions undercut the HHI as a measure of market power.

50. Recent investigations of California telecommunications markets by the U.S. Department of Justice, the California Attorney General, the FCC and this Commission found the use of HHI to be of little value in assessing the market power arising from the mergers of AT&T with SBC and MCI with Verizon.

51. Market share tests are inherently backward looking and not a good predictor of future developments, particularly in a rapidly changing industry like telecommunications.

52. No market is perfectly competitive, but many markets are disciplined by threats of entry and the availability of close substitutes which check the pricing power of market participants.

53. In all markets, competition takes place "at the margins" and competition results from the ability of firms at the margins to increase their production to take advantage of market opportunities.

54. Although a loss of market share demonstrates low market power, market share loss is not necessary to demonstrate a loss of market power.

55. The unbundling requirements developed by the FCC and this Commission check the market power of incumbent carriers in local markets. Verizon has providing data that support this conclusion.

56. Wireless services are a competitive threat to wireline services

57. VoIP technologies compete with historic wireline telecommunications services.

58. Major competitors to ILECs now provide telecommunications services using VoIP technology in California.

59. The abandonment of the UNE-P regulatory strategy does not indicate the failure of the FCC program to open local telecommunications markets.

60. A set residential basic rate is needed to ensure that CHCF-B subsidies enable that social program to meet its policy goals .

61. Neither CHCF-B nor any other social policy program is directly affected by unsubsidized services.

62. Allowing geographically unfettered pricing for telecommunications services not supported by CHCF-B may *improve* market conditions.

63. Price controls are incompatible with the emergence of competition in the voice telecommunications market.

64. Market conditions support pricing freedoms for basic residential rates that are not subsidized by CHCF-B.

65. The removal of price caps on basic telecommunications services is a policy that many forward-looking states are adopting either immediately or with dates certain as they seek to revise telecommunications policies.

66. Continued pricing regulation of LifeLine residential rates will ensure that the Commission is able to adequately support ULTS in accordance with statutory objectives.

67. The Commission shall remain vigilant in monitoring the telecommunications marketplace.

68. There is ample evidence that for the small business segment of the telecommunications market, cross platform-competition is already here.

69. Neither policy nor market conditions support regulations to set the price of new telecommunications services.

70. The realistic threat of entry carriers in any market using UNE-L and the widespread competition offered by wireless, cable and VoIP providers permits prudent policy to rely on market forces rather than regulatory proceedings concerning tariffing and contracting.

71. Establishing a price floor supported by cost data for new telecommunications offerings is a procedure that is no longer needed.

72. The existence of UNE-L prices should, for any ILEC service using a loop, simplify the identification and determination of a "price squeeze."

73. In particular, those services provided on one loop should have a price above UNE-L for that loop.

74. Tariffing and pricing reforms adopted in this decision provide substantial pricing freedoms applicable to all services except those services receiving subsidies.

75. The competitiveness of the telecommunications markets enables us to rely on the market to assure the reasonable pricing of any bundle of services that does not include a service receiving a subsidy.

76. The considerations that led to our restrictions on the general pricing of LifeLine residential service and basic residential services in areas receiving CHCF-B subsidies also require us to limit the inclusion of these services in bundles.

77. Bundles may include any telecommunications service not receiving a subsidy.

78. Since we can rely on the market to assure the reasonable pricing of individual telecommunications services, we can also rely on the market to assure the reasonable pricing of promotions.

79. The federal regulatory policy of requiring that carriers' promotions lasting longer than 90 days be subject to resale requirements provide an appropriate limit on the market use of promotions.

80. Consistent with the Commission's policy that permits different prices for non-subsidized services in different areas of a carrier's service territory, carriers may limit the offering of bundles to particular geographic areas.

81. The inclusion of LifeLine services in promotions makes little market sense.

82. The inclusion of basic residential services in promotions offered in areas receiving a CHCF-B subsidy makes little market sense.

83. Telecommunications markets are ready to adopt the practices commonly used in competitive markets concerning contracting.

84. Current regulatory reviews of contracts no longer serve the public interest.

85. Competitive contracting practices will better serve customer needs that regulated contracting practices that impose reviews that delay the effectiveness of executed contracts..

86. Public policy and the level of market competition advise against the continuation of monopoly era regulations that limit the ability of carriers to withdraw or to grandfather services that are no longer attractive to customers.

87. Regulatory policies continuing such requirements on NRF carriers are incompatible with the statutory goals of technological and competitive neutrality.

88. The parties in this proceeding did not present anything in detail regarding service quality issues, but service quality reports are a large set of the overall monitoring reports.

89. Overall, the parties are in general agreement that California should streamline its monitoring and auditing requirements.

90. Concerning the issue of accounting standards, there is no reason to continue to require a set of regulatory accounts with California jurisdictional adjustments.

91. Experience over the last several years indicates that the NRF-specific monitoring reports were little used.

92. The link between costs and rates was broken nearly twenty years ago with the adoption of NRF.

93. Adopting a policy that allocates all gains or losses to shareholders will simplify the regulatory program and have minimal impacts on ratepayers and is consistent with the economic principle that those who bear the risk should reap the rewards.

94. The companies with which the ILECs compete retain all gains or losses from the sale of their utility property.

95. All parties agree to the elimination of most PUC earnings regulation.

96. There is no longer a need for the NRF regulatory apparatus of price caps, annual price cap filings, "productivity factors," and "sharing of revenues" that are included in the price cap calculations.

97. Firms factor in the risk of future regulation and its potential appropriation of gains in their investment decisions.

98. When there is no justifiable need for monitoring, such as in the competitive environment that exists today in telecommunications, regulatory reports of "regulated" earnings can only distort firms' decisions and conflict with the reports required by financial markets.

Conclusions of Law

1. In addition to striving to meet the goals adopted in the OIR, a new regulatory framework must comply with state and federal statutes and should endeavor to meet the policy goals and conform to the policy preferences incorporated into statutes.

2. State policies for telecommunications, in particular, are set forth in Public Utilities Code § 709.

3. Specifically, Public Utilities Code § 709.5 endorses a reliance on competitive markets to achieve California's goals for telecommunications policy..

4. Public Utilities Code § 882 establishes that regulatory policies should encourage access to a wide choice of advanced telecommunication services.

5. In Public Utilities Code § 871, the Legislature reiterates its intent that our policies encourage development of a wide variety of advanced telecommunication facilities and services.

6. As to universal service programs which promote connectivity of all Californians to the landline telephone system, Section 709 of the PU Code requires affordable and widespread availability of high quality telecommunications services to all Californians.

7. In Public Utilities Code Section 739.3 to ensure the affordability of telecommunications services in high cost areas of California.

8. It is reasonable to consider the impact of any regulatory reform on our state's ability to (i) rely upon competition in the telecommunications marketplace; (ii) encourage development of a wide variety of new technologies and services; and (iii) support our state's public policy programs.

9. The Commission does not have equal authority over all communication service providers.

10. The Commission has different levels of jurisdiction over different providers.

11. Often the Commission's jurisdiction overlaps with that of other regulatory authorities, such as the Federal Communications Commission.

12. The evidence provided by Verizon on the changing pattern of telecommunications use – such as the decrease in access lines coupled with the increase in mobile lines – makes it unreasonable to accept the position of TURN and others that hold that landline and mobile services are complements, not substitutes.

13. There is no compelling reason to segment the market by user characteristics, such as income or use characteristics (such as business or

residential use, level of use, or use by disabled customers) or to include that these groups of customers create a separate market.

14. There is no evidence that the patterns of use by poor customers differ from other customers, or that competition in telecommunications markets will not benefit these customers.

15. Verizon has developed a record in this proceeding that demonstrates that policy, technology, and market developments prevent it from exercising market power in its California service territories.

16. SBC's showing demonstrates that policy and technology also limit its market power.

17. Verizon and SBC have convincingly demonstrated that competitive forces limit market power by maintaining that the unbundling scheme implemented pursuant to the Telecommunications Act of 1996 by the FCC and this Commission makes the provision of telecommunications services by competitors possible in every wire center throughout its service territory.

18. Verizon's demonstration of the presence of competitors throughout its entire service territory makes it reasonable to conclude that Verizon lacks market power.

19. The testimony showing the limited market power of SureWest and Frontier was persuasive.

20. The reliance on HHI calculations is neither legally nor economically justified.

21. Substantial legal precedent addresses the dangers of relying on market share as a measure of competition in regulated markets.

22. Since Verizon, at&t, SureWest and Frontier lack market power in their service territories, price regulation is no longer needed to ensure that prices are just and reasonable.

23. There is no need to find that a telecommunications market is "perfectly competitive" to permit an increase in pricing flexibility and to modify monitoring and report regulations as we have done here.

24. There is no need to demonstrate the loss of significant market share to competitors by the incumbent carriers to justify the modifications to the regulatory program adopted herein.

25. The policy of geographically averaged rates, in conjunction with the CHCF-B program, supports the continued affordability of telecommunications services in areas where the costs of providing services exceed the prices charged.

26. It would be contrary to the Legislature's intent if the Commission no longer required CHCF-B subsidized services to be offered at geographically averaged prices.

27. Neither statutory directives nor market conditions warrant continuation of our geographically averaged pricing policy for services that are not subsidized by CHCF-B.

28. The combination of FCC-mandated unbundling policies, the required provision of stand-alone DSL service by Verizon and AT&T, and substantial cross-platform competition obviate the need for continuing price controls on services not subsidized by CHCF-B.

29. It is reasonable that the Commission eliminate price caps for unsubsidized basic residential rates on a date certain.

30. The Commission shall ensure that basic residential service remains affordable and does not trend above the current highest basic residential rate in the state, no matter the technology employed to offer such service.

31. The Commission retains the authority and firm resolve, should it see evidence of market power abuses, to reopen this proceeding to investigate such developments promptly.

32. It is reasonable to eliminate all price regulations of basic business service.

33. The proposal to permit the provision of new services with full pricing flexibility on a 1-day advice letter filing is most consistent with the statutory framework and current market conditions, because it creates no regulatory obstacles or regulatory uncertainties that would delay the introduction of new services.

34. There is no public interest in maintaining an outmoded tariffing procedure that requires the review of cost data and delays the provision of services to customers.

35. It is reasonable that all tariffs should go into effect on a one-day filing, but any tariffs that impose price increases or service changes require a 25-day advance notice to all affected customers.

36. Contracts should be effective upon execution.

37. Contracts should be filed with the Commission within 15 days after execution in order to enable it and interested parties to ensure that telecommunications carriers do not violate the anti-discrimination requirements embedded in state statute.

38. With the exception of basic residential (1MR and 1FR) and basic business (1MB) services, where the withdrawal of service would raise public safety issues, it is reasonable to require a 1-day filing period before the advice letter becomes

effective and 25-day advance notice in advance of the withdrawal or grandfathering of any service.

39. Bundles can be tariffed under the same rules that apply to the tariffing of any telecommunications services and may be geographically targeted.

40. It is reasonable for California to rely on the federal regulatory policy on promotions, and not otherwise impose restrictions on the duration of promotions.

41. Consistent with the Commission's flexible tariffing of all non-subsidized services, permitting the flexible pricing of all bundles that exclude basic service is reasonable on a one-day tariff filing.

42. Since there is no longer a need to rely on the imputation of costs to ensure that the prices of any tariffed service are reasonable, there is no reason to retain such a requirement for bundled services.

43. It is unnecessary to adopt regulations requiring special disclosures associated with a bundle of services.

44. Because rates are subsidized in both LifeLine service and in certain high-cost wire centers, it is reasonable to prohibit the offering of bundles that include LifeLine services in any area of California, and it is also reasonable to prohibit the offering of bundles that include basic residential service in those wire centers where services receive a CHCF-B subsidy.

45. It is reasonable to permit a promotion to include any service not receiving a subsidy.

46. A promotion should be tariffed under the same one-day rules that apply to the tariffing of any telecommunications service and may be geographically targeted.

47. All carriers should face similar rules concerning the initiation and withdrawal of promotions.

48. Service quality issues should be reviewed.

49. The Service Quality OIR offers the appropriate venue for determining how the Commission should act to promote service quality in this new competitive telecommunications setting.

50. The Commission should defer all service quality issues to the Service Quality OIR.

51. To comply with the statutes encouraging uniform treatment of carriers and efficient regulation, it is reasonable that we adopt the policy that we instituted for AT&T in D.93-02-010, where periodic staff review of the accuracy of monitoring reports was found to satisfy any auditing requirements under the Public Utilities Code.

52. The Commission should adopt the FCC standard accounting practices for California carriers because the current requirement creates a confusing proliferation of regulatory accounts that make utility operations less transparent and accountable, and the regulatory adjustments no longer serve a ratemaking purpose.

53. The Commission should eliminate all NRF-specific monitoring reports rely on the FCC ARMIS data because our experience over the last several years indicates that these detailed reports were little used.

54. The Commission should determine in Phase 2 of this proceeding what information and what reports can best meet the needs in this new environment.

55. Allocating 100% of all gains and losses from the sale of land by ILECs is a modest revision of current rules, which already adopt this policy for property acquired in the last twenty years.

56. Allocating 100% of all gains and losses from the sale of land by ILECs will have minimal impact on rates and is consistent with the principle that those who bear the risk should reap the reward.

57. Allocating 100% of all gains and losses from the sale of land by ILECs is consistent with the rules under which carriers competing with ILECs now operate, and each of these reasons provides a rational basis for the Commission to revise its rules.

58. The Commission should end all the vestiges of the outdated NRF framework and rate of return regulation.

59. The Commission should end price caps, the annual price cap filing, the productivity factor and all residual elements of rate of return regulation, including the calculation of "shareable" earnings.

60. The Commission should also end the reporting of Yellow Page revenues, because the reporting is not required by statute, would cause California accounts to depart from standard accounting practices and thereby make the accounts of ILECs opaque and less subject to oversight.

61. In order to remove the vestiges of NRF and rate of return regulation as set forth in this decision, this order should be effective today.

O R D E R

IT IS ORDERED that:

1. For Pacific Bell Telephone Company, doing business as AT&T California, Verizon California, Inc. (Verizon), SureWest, and Frontier, the four largest incumbent local exchange carriers (ILECs) regulated under the new regulatory framework (NRF), the geographic averaging requirement shall be lifted for all

services other than the California High Cost Fund B (CHCF-B) subsidized basic residential services.

2. Basic residential services receiving a CHCF-B subsidy shall be frozen at a level equal to the current rate, which shall be reevaluated in the upcoming CHCF-B review in Rulemaking (R.) 06-05-028.

3. Price caps on basic residential services that are not subsidized by CHCF-B shall be automatically lifted two years from the effective date of this decision.

4. Basic residential rates shall not fall below at&t's current 1 Measured Rate (1MR) and 1 Flat Rate (1FR) rates, unless R.06-05-028 adopts some other policy consistent with the statutory scheme.

5. All price regulations of basic business service shall be eliminated for at&t, Verizon, SureWest, and Frontier.

6. at&t, Verizon, SureWest, and Frontier shall be authorized to provide new services with full pricing flexibility on a 1-day advice letter filing.

7. at&t , Verizon, SureWest, and Frontier shall be authorized to allow all tariffs to go into effect on a one-day filing, but any tariffs that impose price increases or service restrictions shall require a 25-day advance notice to all affected customers.

8. For AT&T, Verizon, SureWest, and Frontier, contracts shall be effective upon execution; however, they must be filed with the Commission within 15 days after execution.

9. With the exception of basic residential (1MR and 1FR) and basic business (1MB) services, at&t, Verizon, SureWest, and Frontier shall be authorized to withdraw and/or grandfather services effective on a 1-day filing, but the carrier must provide a 25-day or more advance notice to the customer before withdrawing or grandfathering the service.

10. at&t, Verizon, SureWest, and Frontier may freely offer bundles of telecommunications services, but they shall not offer bundles or promotions that include LifeLine services, nor shall they offer bundles that include basic residential service in those wire centers where services receive a CHCF-B subsidy.

11. Pursuant to FCC regulations, at&t, Verizon, SureWest, and Frontier shall offer for resale the services in all promotions that last over 90 days.

12. All service quality issues shall be deferred to Service Quality Order Instituting Rulemaking 02-12-004.

13. We shall adopt the Federal Communications Commission's standard accounting practices for California carriers, and no longer require a set of regulatory accounts with California jurisdictional adjustments. at&t, Verizon, SureWest and Frontier should follow the FCC's standard accounting practices in all filings and reports made to this Commission unless subsequently ordered otherwise.

14. 100% of all gains and losses from the sale of land by at&t, Verizon, SureWest, and Frontier shall be allocated to their shareholders.

15. Price caps, the annual price cap filing, the productivity factor and all residual elements of rate of return regulation, including the calculation of "shareable" earnings are eliminated.

16. The reporting of Yellow Page revenues is eliminated.

This order is effective today.

Dated ____________________________, at San Francisco, California.

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a copy of the Notice of Availability to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the copy of the Notice of Availability is current as of today's date.

Dated July 25, 2006, at San Francisco, California.

/s/ VANA WHITE

Vana White

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